CDAC

CALIFORNIA DEBT ADVISORY COMMISSION

COPs IN CALIFORNIA:

CURRENT ISSUES IN

MUNICIPAL LEASING

Staff Report on June 18, 1992 Public Hearing

KATHLEEN BROWN

State Treasurer and Chair

CDAC 92-6

COPs IN CALIFORNIA:
CURRENT ISSUES IN MUNICIPAL LEASING

Background Paper, Oral and Written Testimony

June 1992

CALIFORNIA DEBT ADVISORY COMMISSION
915 Capitol Mall, Room 400
P.O. Box 942809
Sacramento, CA 94209-0001
(916) 653-3269

STATE OF CALIFORNIA

CALIFORNIA DEBT ADVISORY COMMISSION
915 CAPITOL MALL, ROOM 400
P.O. BOX 942809
SACRAMENTO, CA 94209-0001
TELEPHONE: (916) 653-3269
FAX: (916) 654-7440

Steve Juarez
Executive Director

July 27, 1992

To All Interested Parties:

On June 18, 1992, the California Debt Advisory Commission conducted a public hearing on the growing use of lease financing in California. The hearing, which was held at the Oakland Museum, focused on the increased issuance of *certificates of participation (COPs)* to finance capital improvements and equipment purchases in California. The Commission has prepared this report, *COPs in California: Current Issues in Municipal Leasing*, to provide a public record of what transpired at the hearing. This report includes the background paper prepared in advance of the hearing, a transcript of the testimony received by the Commission, and separate written comments.

Testimony provided at the hearing indicates that the use of lease financing and COPs, in particular, has been integral in allowing public agencies to address their expanding capital and equipment needs over the last decade. While local officials who testified at the hearing indicated their preference for using general obligation (G.O.) bonds for capital projects, the extreme difficulty in garnering the necessary 2/3's voter approval for local G.O. bonds makes leasing one of the few viable alternatives left to public agencies. Thus, the Commission heard wide-scale support for majority-vote approval of local G.O. bonds for capital purposes. Further, it was suggested by a number of speakers that public agencies can increase accountability and support for leasing by adopting COP/lease issuance guidelines and by allowing the public to participate in certain types of lease decisions. Some speakers suggested that the Commission could assist issuers by developing a set of advisory guidelines which would help them reduce finance costs and steer clear of problem areas.

The hearing also revealed the concerns of many regarding the default of Richmond Unified School District on $9.8 million of COPs and the related litigation surrounding the default. Persons speaking on this issue stressed that the outcome of the lawsuit filed on behalf of COP investors could have a devastating impact on the ability of state and local agencies to issue lease debt in the future, especially if the constitutional arguments being advanced by the State Department of Education are upheld. Time and time again, individual testimony pointed out that the Richmond USD financing, which was used to address an operating deficiency, was not representative of leasing practices in California. School representatives also indicated that the implementation of AB 1200 (Eastin, 1991) would help increase State and county oversight of school district finance and reduce the potential for Richmond-type financings to occur in the future.

Despite the problems associated with the Richmond default, the Commission heard testimony which indicates that interest rates for California COPs remain relatively stable, although rates for school district COPs have risen slightly. The flexible nature of COPs, especially those being used to support transportation improvements, was identified as a major reason why they have become so popular in California. Moreover, without the availability of lease-backed financing, it was suggested that California public agencies will either turn to more expensive forms of financing, or will be forced to "bank" funds until sufficient revenues are available to pay for a project or equipment outright. In the latter instance, issuers are likely to incur added costs due to inflation.

In closing, I would like to thank those who testified and shared their expertise with the Commission on this very important topic. In addition, the staff of the City of Oakland and the Oakland Museum, which hosted the public hearing, deserve the Commission's appreciation for their assistance.

Sincerely,

Kathleen Brown

KATHLEEN BROWN
California State Treasurer
Chair, California Debt Advisory Commission

California Debt Advisory Commission

The California Debt Advisory Commission is the state's clearinghouse for public debt issuance information. The Commission was created by the California Legislature in 1981 to assist state and local government agencies with the monitoring, issuance, and management of public debt.

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Additional information concerning this report or the program of the California Debt Advisory Commission may be obtained by contacting:

Steve Juarez
Executive Director
California Debt Advisory Commission
(916) 653-3269

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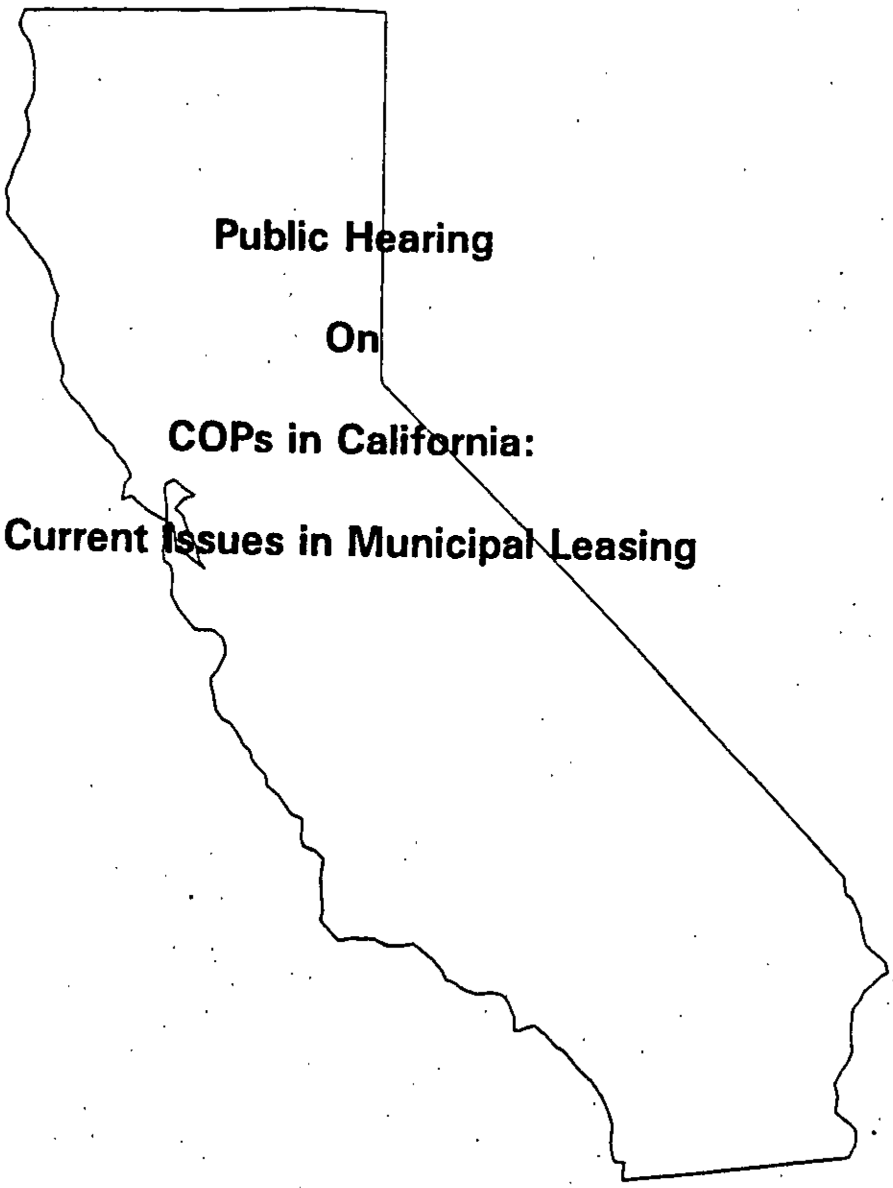


Public Hearing

On

COPs in California:

Current Issues in Municipal Leasing

Oakland, California
June 18, 1992

COPs IN CALIFORNIA: CURRENT ISSUES IN MUNICIPAL LEASING

OVERVIEW

In light of the rigid constraints on the practice of public finance in California, the great discretion afforded to public officials in the area of municipal leasing is something of an anomaly. Because of legal distinctions between leases and debt, local governments can avoid constitutional debt limits, most significantly voter approval requirements, by financing capital projects through lease-backed municipal securities. This flexibility, coupled with new demands on local governments for capital spending, has fueled an explosion in municipal leasing in California over the past decade. *Certificates of participation (COPs)*, the predominant form of lease-backed municipal security, now comprise the largest single type of municipal debt instrument issued in California, based on dollar volume.

Despite the growing reliance of California public agencies on lease-backed financing, the municipal leasing market is more unsettled today than at any time in recent memory. Across the state, a number of cases involving municipal leasing have drawn attention beyond the usual confines of the public finance community:

- *Richmond Unified School District Default.* The default last year of the Richmond Unified School District on $9.8 million of COPs sent shockwaves through the municipal bond industry. The five-year budget plan prepared for the district by its state-appointed administrator does not provide for lease payments on the defaulted COPs. A lawsuit initiated by the trustee for the COPs--which names the State of California and the school district as co-defendants--is being watched closely and could have broad implications for the municipal leasing market. The lawsuit and subsequent brief filed by the State Department of Education also draws into question the use of asset transfers as part of COP structures.

- *Santa Barbara and Nevada County Grand Jury Reports.* In Santa Barbara County, a recent grand jury investigation into the county's use of lease-backed financing led to the release of a report which outlined a series of controversial recommendations, including a proposal to ban the use of COPs for capital projects. A similar inquiry by the Nevada County Grand Jury concluded that the continued reliance of that county on lease financing through the use of a non-elected, non-profit corporation has resulted in a decision-making process for capital spending projects that is not sufficiently democratic.

- *San Jose Baseball Stadium.* The City of San Jose, California recently proposed to finance construction of a major league baseball stadium through a $200 million COP issue indirectly supported by a utility users tax increase. Neither the COP issuance nor the tax increase required voter approval. The matter was put to referendum in the June Primary (and defeated) only because of a city charter provision requiring voter approval of the use of city tax revenues for sports facilities.

- *Beyond California.* Problems in the municipal leasing market have not been confined to California. A much publicized case in Brevard County, Florida raised fundamental questions about the vulnerability of COPs to negative public opinion. The legality of lease agreements has also been challenged in the courts in Virginia and Texas. And a number of state legislatures have considered or are considering statutory changes which would subject lease financing to greater scrutiny and voter involvement.

The cases above raise difficult questions about the appropriate role of municipal leasing in local government finance--questions that will be discussed as part of this paper and at the public hearing on June 18th. To provide a framework for this hearing, this paper begins by defining lease-backed financings and discussing the legal distinctions between municipal lease arrangements and traditional forms of municipal debt. The paper then reviews data which trace the development of the market for lease-backed financings (the terms *lease-backed financing, municipal leasing, tax-exempt leasing*, and *COP financing* are used interchangeably throughout this paper).

After covering the background of municipal leasing, this paper explores some of the current issues surrounding COPs in California. The issues covered are divided into three general areas of inquiry: *Ability and Willingness to Pay*; *Accountability to Voters and Investors*; and *Cost-Effectiveness of COPs*. These three categories are not mutually exclusive: they serve merely as a framework for discussion. Individual lease transactions may, for example, raise questions both about the issuer's ability to pay and the accountability of elected officials responsible for the lease decision.

BACKGROUND ON MUNICIPAL LEASING

The range of government financial activities permitted under the rubric of municipal leasing is quite broad. From acquiring the use of copying machines to financing the construction of multimillion dollar criminal justice facilities, leases serve a broad array of public purposes. When leasing is used to finance capital improvements, the act of borrowing funds is accomplished through the legal framework of the lease, as opposed to the issuance of debt. The primary focus in this paper is the expansion of municipal leasing into activities traditionally undertaken through the issuance of municipal bonds.

As the name implies, municipal leasing involves a lease agreement between a lessor and a lessee. The lessee--typically a government agency--acquires the use or ownership of property or equipment from the lessor by making lease payments over a specified period of time. The lessor may be a private vendor or government agency, but in most cases it is a nominal lessor, such as a nonprofit public benefit corporation, set up explicitly for the purpose of executing municipal lease transactions. Rather than directly issuing debt, the public agency executes a lease agreement with the nonprofit corporation, which is the legal entity responsible for raising the funds needed to construct or acquire the asset. Once the asset is in place, it is leased back to the public agency by the nonprofit corporation. Public agencies are empowered to enter into municipal leases by their authority to *acquire or dispose of property*, rather than their authority to *incur debt.*

Municipal leases are not legally classified as debt because of the abatement and/or nonappropriation clauses included in the lease agreement. An *abatement clause* makes the lessee's obligation to appropriate lease payments contingent upon the use and occupancy of the leased property. If the property cannot be utilized because of construction delays or damage, the lessee is relieved of the lease obligation. A *nonappropriation clause*, which is not required under California law, permits the lessee to terminate the lease if its appropriating body does not allocate sufficient funds. Lease-backed financings in California typically include a *covenant to budget and appropriate*, which binds the lessee for the term of the lease as long as it has use of the property.

When a large amount of money is needed to pay for the construction of a major capital item, public agencies generally find it advantageous to issue *certificates of participation* (COPs) through the nonprofit public benefit corporation. COPs are municipal securities which entitle the investor to a fractional share of the lease payments on a specific project. The certificates are divided into increments of $5,000 for sale to the ultimate investors, who are mostly bond funds, individual investors, and financial institutions. The proceeds from the sale of the COPs are used to finance the construction of the capital asset, which is leased back to the public agency by the nonprofit corporation. The public agency then makes annual lease payments on the project which are used to retire the outstanding COPs.

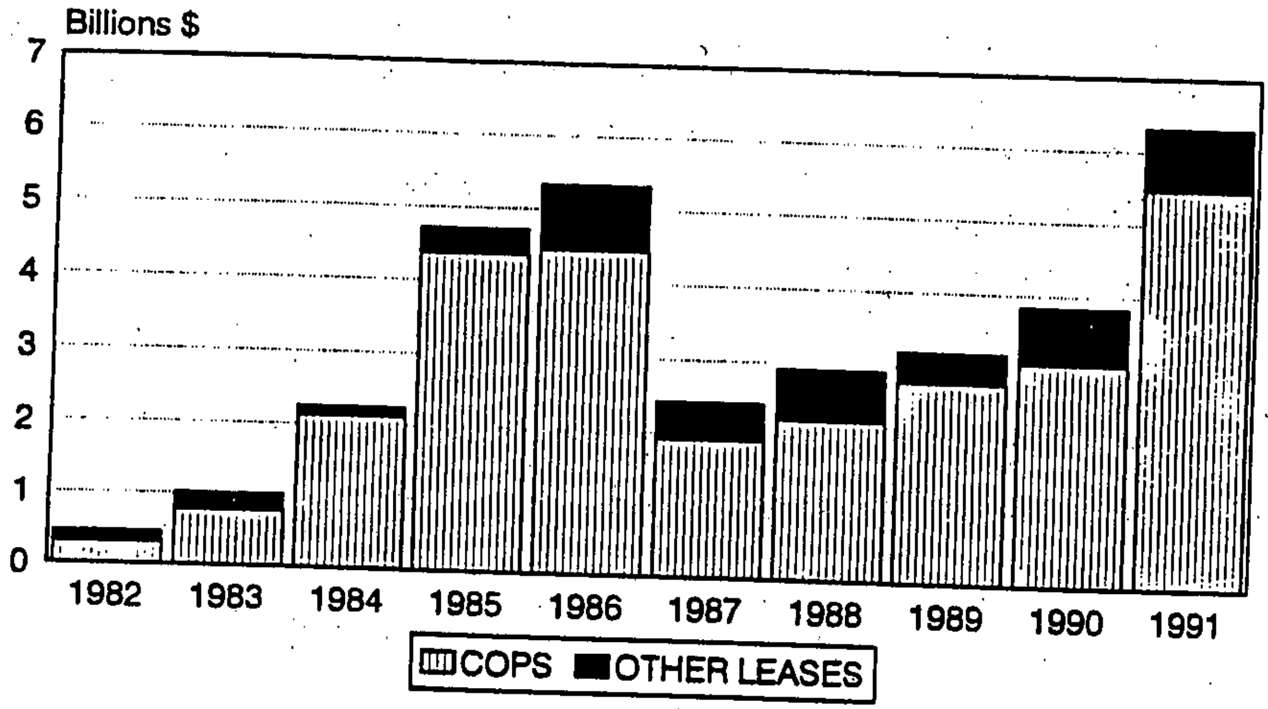
While COPs adopt the formal aspects of lease agreements, they result in the transfer of title to the lessee at the end of the lease term. The lease payments are structured to include a principal and interest component--much like the debt service for a bond issue. The Internal Revenue Service treats lease agreements which transfer title to the lessee as conditional sales agreements, and the interest component can be excluded from gross income for federal tax purposes. Consequently, government agencies can issue lease-backed securities at tax-exempt interest rates, providing an attractive alternative to traditional tax-exempt municipal bonds.

Historical Development of the Lease Market. Public agencies in California have utilized lease-backed financing for decades. California case law on municipal leasing dates back to 1933, and a series of cases during the 1940s and 1950s established the principle that a binding long-term lease with vesting of title at the end of the term does not create debt for public agencies (the "Offner-Dean" rule). The volume of lease-backed financing by local governments in California sharply accelerated in the aftermath of the passage of Proposition 13 in 1978. By capping *ad valorem* property tax rates at one percent of assessed value--except for any additional levy needed to support prior voter-approved debt--Proposition 13 effectively eliminated the ability of local governments to approve new general obligation bonds (local general obligation bonding authority was not restored until the passage of Proposition 46 in 1986).

In addition to Proposition 13, other developments contributed to the expansion of the municipal leasing market during the early 1980s. The federal government severely curtailed grants to local governments which had supported many public works projects during the 1960s and 1970s. Moreover, the period of economic growth following the 1982 recession created new demands on local governments for infrastructure spending. Compliance with new federal environmental regulations required substantial investments in water and sewage treatment systems, but the issuance of revenue bonds for these purposes was hampered by statutory interest rate ceilings and competitive bid requirements. Thus, public officials often found

Chart 1

TEN YEARS OF MUNICIPAL LEASING IN CALIFORNIA 1982-1991



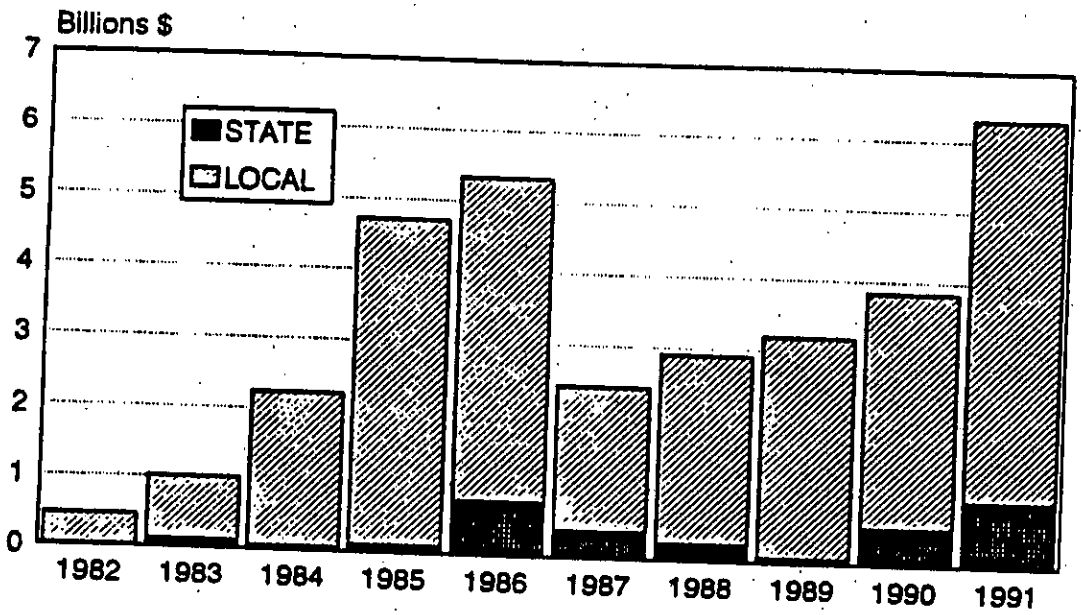
Source: CDAC

municipal leasing to be the most appropriate--if not the only--option available for responding to these needs.

Twin Peaks in Issuance Levels. Chart 1 displays the level of municipal leasing in California for each year dating back to 1982. This chart shows that there have been two distinct peaks in the issuance of municipal debt: first in 1986, when there was the "rush to issue" before the effective date of Federal Tax Reform Act; and second in 1991, when favorable interest rates created an environment ripe for new lease issues and refinancings. Since 1987, reliance on leasing has steadily increased, with a significant jump in 1991. Chart 1 also illustrates that COPs have been the predominant form of municipal leasing in California since 1982.

Chart 2

COP AND LEASE ISSUANCE BY STATE AND LOCAL AGENCIES 1982-1991



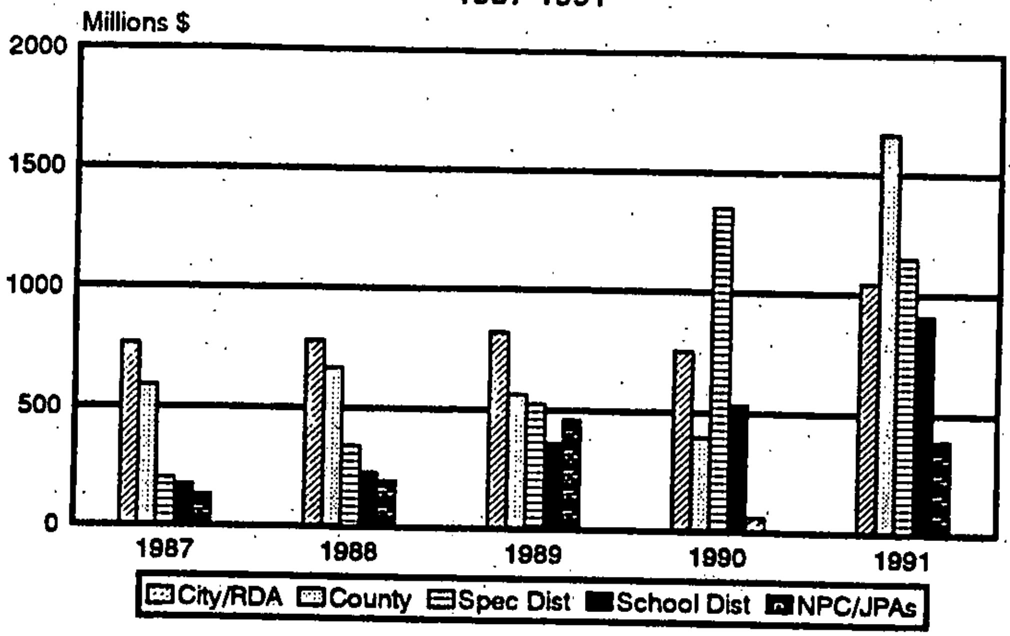
Source: CDAC

Local Agencies Responsible for Bulk of Lease Issuance. Chart 2 above breaks down the issuance of lease-backed securities by state and local agencies. As Chart 2 illustrates, local agencies have issued the vast majority of lease-backed securities over this ten-year period. Insofar as local agency COPs comprise the bulk of lease-backed securities issued in this state, this category is the focus of our interest and discussion.

The relatively low reliance of the State on COPs and lease-revenue bonds to support capital improvements undoubtedly reflects the successful passage of State general obligation bonds during the 1980's, although the level of State lease-revenue bond debt has started to escalate recently. As asserted later in the section on *Accountability*, the majority vote approval provisions which apply to State general obligation bonds make this form of financing a viable tool for the State. If this same authority was granted to local jurisdictions, we assume that their reliance on lease debt would decline markedly, although not entirely. Even if majority vote provisions did apply to local G.O. bonds, COPs would likely still be the tool of choice for large equipment purchases, some capital outlay items, and nontraditional long-term obligations of local governments.

Chart 3

COP ISSUANCE BY TYPE OF LOCAL AGENCY 1987-1991



Source: CDAC

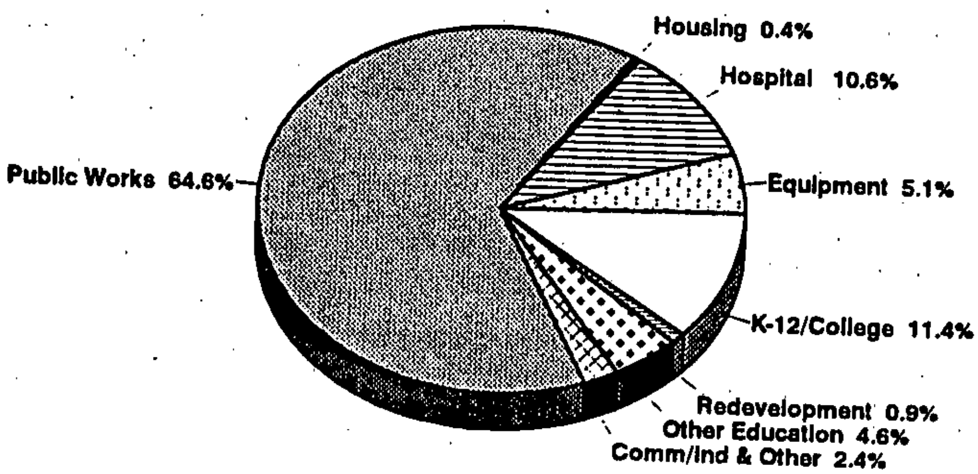
Large Increases Over the Past Five Years. Chart 3 above tracks the level of COP issuance for different types of local agencies over the past five years: cities and redevelopment agencies (combined), counties, special districts, school districts, and nonprofit corporations and joint powers authorities (combined). Although virtually all types of local agencies increased their use of COPs during this time-period, Chart 3 illustrates especially dramatic increases in COP issuance levels for counties, special districts, and school districts.

The build-up of COP issuance for special districts and school districts has been especially strong since 1987, following federal tax reform. Special districts, for instance, sold 20 COP issues worth $202 million in 1987. By 1990, the amount issued had reached a high of 44 issues worth $1.35 *billion*. School districts issued 30 COPs in 1987 valued at $174 million. By 1991, the figures for school districts were 104 issues worth $914 million. As the figures indicate, COP issues for both special districts and school districts have not only become more common since 1987, they have also become larger in average dollar size.

Chart 4

LOCAL COP ISSUANCE BY PURPOSE

1987-1991



Source: CDAC

Most COPs Finance Public Works. Finally, Chart 4 displays local agency COP issuance by purpose on a cumulative basis for the past five years. Public works, a broad category covering a range of infrastructure items, accounts for 64.6 percent of the total. Hospital facilities account for 10.6 percent of the total and K-12 and community college facilities (combined) account for 11.4 percent of the total. Equipment COPs total 5.1 percent for the five years, while other educational purposes, a category comprised of temporary school facilities and equipment, accounts for 4.6 percent of the total. Commercial/industrial purposes account for 2.4 percent of the total, and redevelopment accounts for 0.9 percent of the total.

Questions for Discussion:

1. To what extent can the dramatic increase in municipal leasing volume last year be attributed to lower interest rates and greater refunding activity?

2. What other factors are contributing to the increase in COP issuance? Are local agencies turning to COPs to avoid restrictions on other forms of debt?

ABILITY AND WILLINGNESS TO PAY

As the recession continues to take its toll on revenue collections at all levels of government, investors, insurers, and other industry professionals have become concerned about the ability and willingness of public agencies to honor their lease commitments. Fortunately, the municipal bond market is very proficient at gauging the level of risk associated with public debt offerings, including municipal leases. Before a lease-backed security is offered in the market, the risk of nonpayment is usually analyzed by the credit rating agencies and often by institutional investor groups and credit enhancement providers. In 1991, for example, 95 percent of the COPs issued in this state were rated, and 51 percent were credit-enhanced.

Notwithstanding the legal distinctions between leases and debt, rating agencies and investors generally view lease-backed financings as long-term debt obligations. The credit analysis for lease-backed financings tends to focus on three main factors: *the lessee's general creditworthiness; the security features of the lease agreement; and the essentiality of the project being financed.* The first two factors are primarily concerned with the resources available to the public agency to meet its lease obligation, or its *ability to pay.* The third factor provides an indication of the lessee's ongoing commitment to the project, or its *willingness to pay,* which may be influenced by nonfinancial factors.

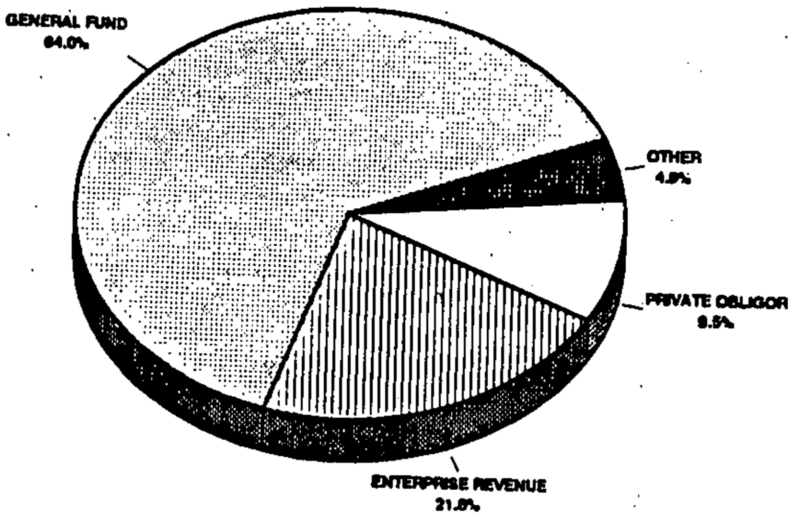
Credit Analysis of Lease-Backed Financing

Lessee's General Creditworthiness. In most cases, the issuer's creditworthiness is highly influenced by the strength of its economic base, insofar as the economy generates the tax revenues which ultimately support the lease payments. The issuer's overall debt burden, calculated as the ratio of debt service to general fund expenditures or revenues, is also an important consideration. The rating agencies factor lease obligations into their debt burden calculations. High debt burdens can hinder an issuer's ability to cope with adverse economic circumstances, potentially jeopardizing lease payments. The debt service ratio also serves as a benchmark of where the issuer stands relative to comparable governmental units.

Lease Security Features. Also central to the credit analysis is the structure of the lease itself, particularly the term of the financing and the revenue source pledged to lease payments. Lease security is greatest when the term of the lease does not exceed the useful life of the project. On the issue of repayment strength, Chart 5 on the next page breaks down local agency COPs issued in 1991 by four repayment sources: (1) General Fund of the Issuing Agency; (2) Enterprise Revenues; (3) Private Obligor (mostly health care facilities and housing); and (4) Other (which consists of property tax revenues, property tax increment revenues, special tax revenues, special assessments, bond proceeds, and grants). Chart 5 shows that the vast majority of local agency COPs issued in California are supported by annual general fund appropriations rather than dedicated revenue sources.

Chart 5

COP ISSUANCE BY REPAYMENT SOURCE
CALIFORNIA LOCAL AGENCIES
1991



Source:CDAC

Because COPs which are supported by general revenues compete with other operating expense priorities, such COPs are especially sensitive to an issuer's fiscal condition. Thus, for most general fund-supported leases in California, lessees typically *covenant to budget and appropriate* lease payments. This is an important security feature which binds the lessee to the term of the lease as long as it has use of the property.

For lease-backed financings supported by enterprise revenues, the credit analysis is similar to that of a revenue bond, focusing on project feasibility and rate covenants. Utility districts and municipal enterprises have the option of structuring their COP issues as installment sales contracts, which are absolute and unconditional during the term of the lease agreement, thereby eliminating abatement risk. COP issues structured as installment sales contracts can be rated as high as the issuer's senior rating.

The credit analysis also evaluates the adequacy of the insurance provisions structured into the lease agreement. Because most COP issues in California are subject to abatement risk, the lease agreement usually will require the lessee to purchase insurance to protect against property damage caused by fire or natural disasters. The analysis of lease security features also focuses on the legal remedies to default available to the lessor. The lease agreement may provide the lessor a security interest in the leased property with the right of possession in the event of default. To protect investors against bankruptcy of the lessor, there may be a sale and absolute assignment of lease payments to the trustee, so that the lease payments would not be considered property of the lessor's estate under the federal bankruptcy code.

Project Essentiality. Last but certainly not least, the credit analysis attempts to surmise the essentiality of the leased property to the lessee. Legal loopholes notwithstanding, a lessee is more likely to continue budgeting for a project that serves an essential purpose than for a project it can easily do without. Along this line of reasoning, a school building would normally be viewed as serving an essential purpose for a school district. Conversely, a waste-to-energy cogeneration facility, such as the type financed (and defaulted upon) by the Lassen Community College District in 1983, might not be seen as essential to the mission of the district.

School District COPs & the Richmond Case

Over the past couple of years, concerns over the creditworthiness of tax-exempt leases have focused more on school districts than any other type of public agency. At the root of school district financial difficulties are the same budgetary pressures facing other public agencies--increasing service demands and stagnant revenues. Yet, due to budgetary and legal constraints which affect school finance, in particular, school administrators are especially hard-pressed to address these pressures. For instance, because California school districts, on average, receive about 75 percent of their revenues from the State, they have limited ability to forecast and control annual revenue streams. Moreover, constitutional restrictions on taxation inhibit their ability to generate additional funds at the local level. On the expenditure side of the ledger, school district operations are very labor intensive: personnel costs comprise, on average, about 80 percent of school district operating expenses, making it harder for school districts to control costs.

In terms of financing capital facilities, California school districts must either obtain a two-thirds majority vote for local general obligation bonds, seek developer fees or special tax funding through Mello-Roos bonds, or endure a lengthy wait for State general obligation bond proceeds, which are far from guaranteed. Depending on the particular circumstances of the school district, these options may be unrealistic or unacceptable. Thus, lease financing, and more specifically, COP financing, is often the only viable method of funding available to support school facilities.

One form of COP school financing which appears to be growing in popularity is the use of COPs as interim or bridge funding until a school can receive State G.O. bond funds. Schools which have State approval, and are in line for funding from the State Allocation Board, can advance the construction of school facilities by issuing COPs and then using reimbursement from the State to retire the COP issue. Schools which advance fund the construction of facilities in this manner are eligible to receive reimbursement for the cost of issuance and principal amount of the COP, and up to two years of interest payments.

AB 1200 Increases Oversight. Because of the budgetary pressures facing school districts, last year the Legislature enacted AB 1200 (Eastin) to provide for increased oversight of school district finances. Among other things, AB 1200 authorizes county superintendents of education to review the budgets of school districts on an annual basis and to assist the State Superintendent of Schools in developing a list of financially troubled districts which are certified as *negative* (meaning the school district will not be able to meet its financial commitments through the end of the school year) or *qualified* (which means that the district will not be able to meet its commitments, unless certain events occur). Districts certified as negative or qualified may not issue debt, including lease-backed debt, without permission of their county superintendent of education.

Prior to the enactment of AB 1200, however, at least two troubled school districts did issue COPs to cover operating deficits, and a third school district issued a privately placed COP for the same purpose. In a much-publicized transaction in 1988, the Oakland Unified School District issued $13.5 million in unrated COPs to cover a major deficit faced by the district. Despite the infusion of COP proceeds, Oakland USD subsequently received a state emergency loan and came under the supervision of a state-appointed trustee. The district's finances appear to be on the mend, however, and it is not currently on either the negative or qualified list for 1991-92.

In 1991, the Montebello Unified School District issued a $12.4 million privately placed COP with the County of Los Angeles as a short-term response to the district's budget woes. During the 1990-91 school year, Montebello USD was certified in the negative category and this year the district has been upgraded to a qualified status. Nevertheless, Los Angeles County still holds Montebello's COP debt as part of its local treasury pool.

Richmond Unified School District COP Default. The default last year of the Richmond USD on $9.8 million of COPs focused national attention on the creditworthiness of California school district lease obligations. The default resulted from management decisions to implement a series of costly educational reforms which could not be supported by the district's revenue base. In response to a growing gap between expenditures and revenues, the district engineered a complicated lease-leaseback of school district facilities to generate funds to cover an operating deficit. Nevertheless, the district declared bankruptcy on April 19, 1991, only to withdraw its bankruptcy petition under the direction of a state-appointed administrator the following fall. However, the five-year budget plan for the district drawn up by its state-appointed administrator does not include funds to service the outstanding COPs.

The state and the district have been named as defendants in a lawsuit filed by the trustee for the COPs, U.S. Trust of New York. In a brief filed in response to the lawsuit, the State Department of Education has charges that the leaseback arrangement underlying the defaulted COP issue is invalid and unenforceable. According to the brief, the leaseback arrangement created debt in violation of Article 16 of the State Constitution, which requires voter approval of such debt. The Department of Education asserts that the leaseback arrangement created debt because it mortgaged assets that the district had owned free and clear, and no asset was received in return. In addition, the brief charges that the contract is unenforceable because the lease payments exceed the fair market value of the assets being leased, and because the underwriter for the COP issue misrepresented to the district its obligation to honor the lease contract.

Until the courts have had the opportunity to render decisions on the numerous charges and countercharges stemming from the Richmond lawsuit, or until an out-of-court settlement is reached, it appears the leasing environment in California will remain unsettled. For example, the Fresno Unified School District encountered difficulty in attracting investors in a $35 million COP issue in February of this year. Although the issue did eventually sell, it is generally believed that the controversy surrounding the Richmond case (in addition to local factors) did have an impact on investor interest in Fresno USD's certificates.

Questions for Discussion:

1. Is there any evidence that local agencies are overcommitting their operating budgets to lease payments?

2. Is statutory clarification needed on the issue of whether California public agencies, including school districts, may covenant to budget and appropriate lease payments?

3. What will be the implications for the lease market in California if (a) the Richmond COP trustee lawsuit is successful, or (b) if the court invalidates the leaseback arrangement for the reasons outlined in the State Department of Education brief in the Richmond case?

4. Is the option of taking possession of school district assets a meaningful remedy for default?

5. Is the AB 1200 process an adequate safeguard for protecting against shaky COP issues?

6. What proportion of school district COP issuance represents temporary "bridge financing" issued in anticipation of grants from the State Allocation Board?

ACCOUNTABILITY TO THE PUBLIC AND INVESTORS

Because municipal leases do not require voter approval, elected officials entering into lease agreements may face questions about their accountability to the electorate. In fact, recent grand jury reports in Santa Barbara and Nevada counties have taken the view that municipal lease agreements should be subject to greater voter oversight. From another point of view, however, elected officials who approve lease transactions *are accountable* in the most fundamental way: voters can turn them out of office if they are displeased with their actions.

Nevertheless, the issue of subjecting lease agreements to greater scrutiny, and potentially voter involvement, is worthy of discussion for a couple of reasons. First, the distinctions between lease obligations and public debt are based more on fine legal points than on substantive differences in form or purpose. Thus, to the extent that certain leases will result in long-term obligations, there may be merit in viewing such transactions in the same light as public debt issuance. Second, the decision to employ a lease structure instead of bonds can be one of expedience, rather than the outcome of a cost-benefit analysis of financing alternatives. In essence, lease-backed structures are often chosen not for what they are, but for what they are not.

The question of voter approval requirements for municipal leasing should be examined with the broader framework of the constitutional and statutory constraints on public indebtedness in California. If the existing debt limits serve as appropriate checks on public borrowing, logically they should be extended to leased-backed financings. If these constraints are overly restrictive, however, public officials may need the flexibility to enter into lease arrangements in order to ensure adequate public service levels.

Reasons for Voter Approval of Public Debt

In theory, voter approval requirements for municipal bond measures serve two basic policy objectives: the first is to keep government from becoming over-indebted; the second is to gauge voter preference for specific capital projects.

Voter Approval as a Constraint on Public Indebtedness. The State Constitution requires that general obligation bond measures of cities, counties and school districts receive two-thirds voter approval. The constitutional assembly which drafted the State Constitution of 1879 included this provision in response to the widespread municipal bond defaults which resulted from the depression of 1873. Prior to that time, local borrowing had been controlled by the Legislature, which freely authorized municipal bond measures without the consent of local voters. The two-thirds vote requirement was erected as a barrier to reckless borrowing.

The century following the enactment of the two-thirds vote requirement witnessed countless improvements in public administration--from the establishment of government accounting standards to the development of a professional corp of administrators--which contributed to the financial stability of the public sector. The financial markets themselves developed highly sophisticated analytical techniques for sorting out government credits. The modern practice of public finance employs all of these resources to balance public demands for capital spending with available resources. In addressing demands for capital spending, government finance officers seek the appropriate mix between current revenues and borrowing--and within the realm of borrowing--between tax-supported debt and self-supporting debt.

The main danger arising from the use of municipal leasing today is that governments will overcommit their budgets to lease obligations, which are fixed commitments that diminish the budgetary flexibility that is needed to cope with revenue shortfalls. While this danger is real, it does not logically follow that the electorate is imbued with some innate ability to determine how expenditures should be distributed between capital and operating components. On what basis, for example, would voters decide whether a government should devote 2 percent versus 4 percent of its annual budget to lease payments?

Rather, the establishment of appropriate thresholds for lease debt is best accomplished through a deliberative process that takes into account economic and fiscal conditions, as well as the policy objectives of the community. And the most appropriate means for carrying this out is through the establishment of debt management policies which restrict the use of leasing to legitimate purposes, and which specify thresholds for lease debt. By adopting such policies, public officials not only demonstrate their willingness to keep lease debt within acceptable parameters, they also help improve the overall management of their budgets.

To increase accountability to the public, debt management policies should be established as part of a public hearing process, thereby allowing for a healthy dialogue between public officials and their constituents. While we should not expect the public to become experts on government finance, their participation in shaping debt management policies does afford a degree of control and accountability which is both reasonable and warranted.

Voter Approval To Indicate Preference. Concern over absolute levels of indebtedness is not the only reason for establishing voter approval requirements for lease transactions. In most instances, referendums offer the only sure-fire way to determine whether the public supports a proposed capital spending project. The question in this instance is not whether a government can afford a proposed lease financing, but whether the public wants its tax dollars spent on the project.

What appears at first blush to be a black-and-white issue can be actually quite complex. Public officials make spending decisions, including lease decisions, all the time without direct voter involvement. This is not only a practical reality, it reflects our representative form of government. Subjecting *all* leases and COPs to voter approval would seriously jeopardize government's ability to address capital outlay and equipment needs in an efficient and timely manner. Therefore, the difficult policy issue involves balancing the decision-making authority of elected officials against the direct participation of the electorate in important spending decisions. In this regard, local officials may want to consider establishing criteria as part of their debt management policies which would dictate when lease transactions may warrant voter involvement.

One criterion for determining when voter approval may be appropriate involves whether the proposed lease financing requires a tax increase, especially in instances where a local agency maintains the discretion to avoid such a vote. Although Proposition 13 and Proposition 62 were intended to subject all tax increases to voter approval, the courts have ruled that charter cities retain substantial discretion over taxation matters under the municipal affairs doctrine of the State Constitution. Consequently, charter cities can raise some taxes, such as the utility users tax, without voter approval. The proceeds from the tax increase can support lease payments on a COP or other lease-backed financing. In addition, revenue-producing government enterprises, such as sewer and water districts, can structure lease financings as installment sales contracts, thereby avoiding the voter approval requirements that apply to revenue bonds. Enterprise revenues are legally classified as fees-for-service, rather than taxes, and therefore are exempt from constitutional restrictions on taxation.

The argument for voter approval requirements for lease-backed financings need not be limited to only those proposals requiring tax increases. For example, a major lease transaction may claim a significant stream of governmental revenues for a long period of time. Even if the lease is paid out of existing revenues, it could preclude other projects or programs from being funded. In such cases, it may be useful for issuers to gauge the relative priority of such projects by direct voter involvement. In cases where the project involved is controversial, putting the lease proposal to referendum precludes charges that the agency is attempting an "end-around" popular sentiment.

A Matter of Local Prerogative. Clearly, there are good reasons to subject at least some lease proposals to the electorate. But for legal and practical reasons, this matter is best left to local governments to decide. From a legal perspective, the State is powerless to intervene in many of the fiscal decisions facing charter cities because of the municipal affairs doctrine of the State Constitution. From a practical perspective, local policymakers are in the best position to judge which lease transactions are controversial or otherwise warrant voter involvement.

If there is justification for placing at least some lease proposals before the public, what level of public support should be required for approval? Here the distinction between voter approval as a constraint on public indebtedness and as an indicator of voter preference is especially important. Because the objective in this instance is to gauge voter preference, it seems reasonable that the majority should dictate approval or disapproval of a lease project. Otherwise, the matter of preference becomes not what the majority wants, but what the minority will allow them to have.

Finally, it is worth noting that the State has not followed the same path as local agencies in its use of lease debt during the decade of the 1980s. The lower reliance of the State on leasing reflects its ability to approve general obligation bonds with majority voter approval. As a consequence, the State was able to rely on G.O. bonds to respond to its infrastructure needs over the past decade. It seems reasonable to assume that if local agencies enjoyed similar authority, reliance on lease debt would decline, although there might still be instances where lease transactions would make sense and offer a sound alternative to bonds.

Accountability to Investors. The issue of accountability is not confined to public officials and voters. Once lease-backed securities are issued, public officials are also accountable to the investors who purchased these securities. While investors are compensated for relative degrees of risk through interest rate differentials, their decision to purchase individual lease obligations is based upon the assumption that the issuer will faithfully comply with covenants to budget and appropriate and other legal requirements specified in the bond documents.

Fortunately, investors are relatively easy to keep happy: they just want to be paid in full and on time. If the issuer maintains a reasonable debt burden, the resources needed to meet the lease obligation should be available. Perhaps the greater danger stems from mounting public opposition to a project after the lease agreement is executed. This was the case in Brevard County, Florida, where the Board of Supervisors initially voted last December to subject an existing COP agreement for their county administrative complex to voter referendum.

Although the Board of Supervisors in Brevard County eventually reversed its decision in February of this year, it was only after investors, rating agencies, and others in the public finance community made it clear that the county would pay a substantial price in the marketplace if the COP transaction went to public vote *after* the transaction had been completed (and after the county was occupying the facility). The lesson to be learned from the Brevard County situation is simple: the decision to seek voter approval on a lease transaction should be made *before* entering into lease agreements, not after the COPs have been sold.

Questions for Discussion:

1. What level of discretion is appropriately reserved for public officials to enter into lease agreements?

2. Does it make sense for local governments to adopt formal debt management policies which specify, among other things, the terms and conditions under which they consider lease-backed financing?

3. Could CDAC be of help, for example, by developing model guidelines for authorization and issuance of COPs?

4. Would the approval of a constitutional amendment permitting simple majority approval for local general obligation bonds reduce the reliance of local governments on lease financing?

COST-EFFECTIVENESS OF COPs

The goal of any asset acquisition decision is to obtain use of the asset at the lowest possible cost. Ideally, that decision is the product of a cost-effectiveness evaluation of available financing options. In the public finance arena of California, however, the financing decision is often dictated by political expedience. The two-thirds vote requirement for local general obligation bonds is the Maginot Line of public finance in California; it does not stem the flow of public borrowing as much as channel it toward lease-backed financing. Does the resulting pattern of public borrowing reflect a cost-effective use of public resources?

It is difficult to make sweeping generalizations about the cost-effectiveness of COPs, because they can be structured to suit a variety of purposes. Any analysis of this sort must target specific sectors of the COP market. Within individual sectors, it is then possible to make some observations on the cost-effectiveness of the leasing option.

COPs Supported by General Funds. Because COPs are not backed by the full faith and credit of the issuing agency, they usually are rated lower than the same issuer's general obligation bonds. While the rating differential depends upon a variety of factors, it is usually not more than one full grade. The lower credit rating translates into an interest rate premium on COPs relative to the same issuer's general obligation bonds.

The COP structure also requires features not found in general obligation bonds, such as reserve funds, capitalized interest accounts, rental interruption insurance, performance bonds and builder's risk insurance, and possibly credit enhancement premiums. In addition, the issuer may face added legal costs to establish a nonprofit public benefit corporation.

Despite the added costs, COPs may be preferable to general obligation bonds for certain projects, the voter approval obstacle notwithstanding. COPs, and other lease-backed securities, permit local agencies to address capital outlay needs within their current revenue base while breaking out of the confines of "pay-as-you-go" financing. Local general obligation bonds, by contrast, impose an additional tax burden. Furthermore, bonds may not be the most appropriate means to finance the acquisition of items like equipment or to capitalize nontraditional types of long-term indebtedness such as self-insurance trust funds.

Asset Transfers. One way to avoid many of the added costs of issuing COPs is to structure the transaction as an *asset transfer*. Under an asset transfer structure, the issuer sells or leases an existing asset that it owns outright in order to generate funds for the construction or acquisition of a separate asset. For example, a municipality might enter into an agreement to sell its City Hall and lease it back, using the proceeds from the sale to construct a museum. Asset transfers can produce cost savings in two ways. First, the credit rating for the transaction is based upon the asset securing the lease--the original asset. If the original asset serves a more essential function to the municipality than the new asset, the transaction will receive a higher credit rating structured as an asset transfer, resulting in lower interest costs. Second, the asset transfer substantially reduces the risk of rental abatement, because the lease is secured by an existing asset, rather than one yet to be constructed. Consequently, the asset transfer structure eliminates the need for capitalized interest and construction insurance.

Asset transfers may engender political opposition because they involve mortgaging assets that a municipality owns outright. However, if the proceeds are used to acquire an additional capital asset, such criticisms may be unwarranted. True, the municipality will be required to make lease payments on an asset that it previously owned outright, but it will *not* have to make lease payments on the newly acquired asset. The "mortgaging our assets" complaint seems better suited to those instances where the proceeds from the asset transfer are used to fund an operating deficit, as in the Richmond USD case.

COPs Supported by Enterprise Revenues. For revenue-producing projects, there may be no rating differential between a COP structured as an installment sales contract and a revenue bond. The installment sales contract obligates the lessee for the term of the lease agreement, eliminating abatement risk. The COP also can be structured with rate covenants and legal protections equivalent to those of revenue bonds. Consequently, the viability of the proposed project, rather than the form of the financing, will determine interest costs.

Master Leasing. In the area of equipment leasing, public agencies can realize efficiencies by executing *master leases*. Master leases permit public agencies to acquire various pieces of equipment from different vendors over a period of time under one lease contract. Consequently, the public agency is relieved from the necessity of financing each acquisition separately--which can be quite expensive under the terms offered by equipment vendors. Master leases can also be used to consolidate outstanding leases.

Recent Innovations: COPs Secured by State and Federal Funds. Two recent COP transactions from California's Central Valley involve revenue sources which have not traditionally secured debt obligations. Last year, the City of Fresno, through its Joint Powers Financing Authority, issued $11.2 million of COPs backed by State gas tax revenues (Approximately one-half of state gas tax revenues are distributed to cities primarily on the basis of population and to counties chiefly on the basis of vehicle registration.) The first COP issue secured by gas tax revenues in California was made possible by voter approval of Proposition 111 in June 1990 (which raised the gas tax by five cents per gallon in 1990, with an additional cent per year until 1994).

Earlier this year, the Sacramento Regional Transit District, through the nonprofit California Transit Finance Corporation, issued $31.8 million of COPs secured mostly by federal funds. Specifically, 80 percent of the lease payments is are backed by Federal Transit Administration funds and 20 percent is backed by local and state sales tax revenues. The proceeds from the COP sale will be used to purchase 75 replacement buses, a radio network, and a fare collection system. By issuing the COPs instead of purchasing the buses over a four year period, the Sacramento Regional Transit District was able to generate $1.7 million in inflation savings.

Both the Fresno and Sacramento transactions demonstrate how COPs can be used to capitalize ongoing revenue streams to generate cash for capital improvements. Given the needs of issuers and the inventiveness of the marketplace, we are likely to see more innovations in COP financing in the future.

Questions for Discussion:

1. For enterprise facilities, are the overall issuance costs of COPs comparable to those of revenue bonds?

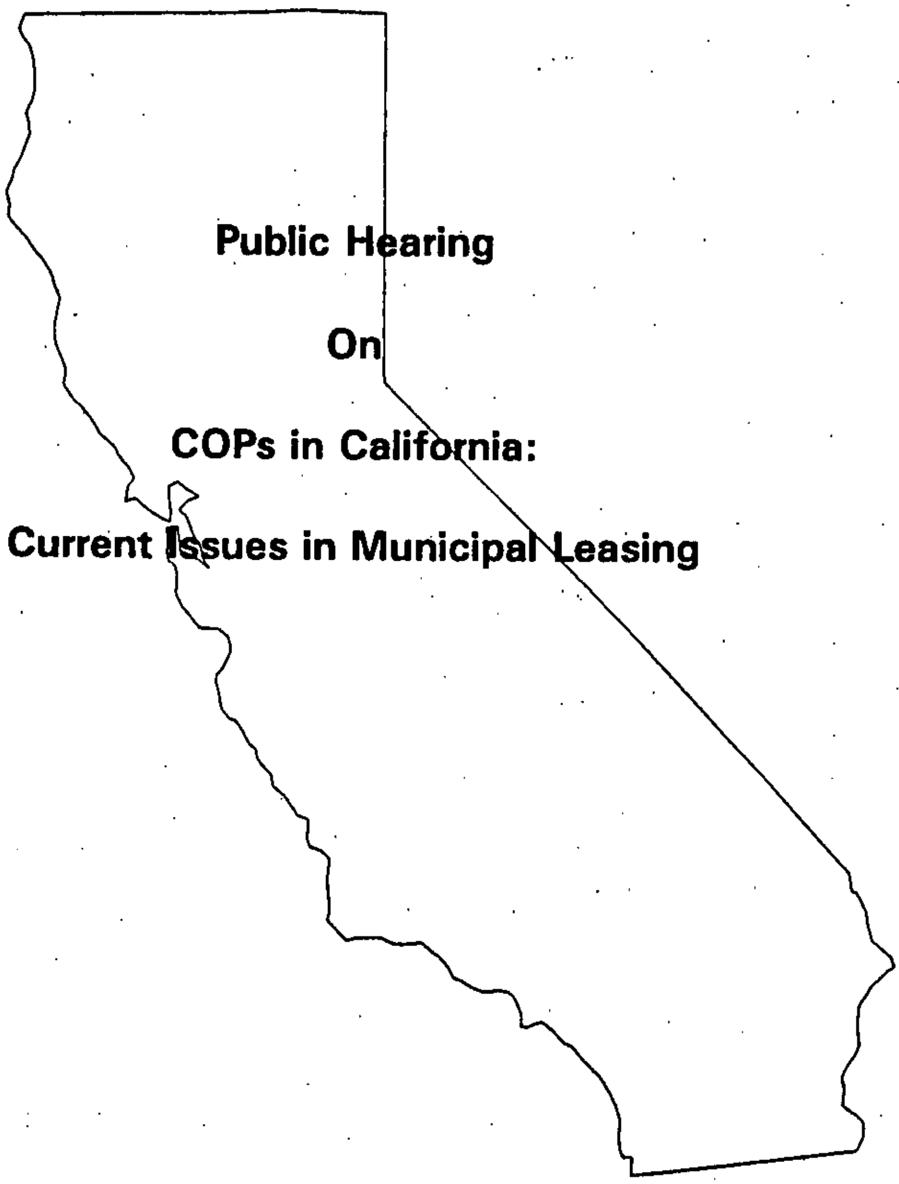
2. Are we likely to see more interest in some of the newer innovations, such as the COPs secured by state gas tax revenues and federal funds?

3. Are there any dangers in structuring COP issues as asset transfers?

4. What are some of the advantages of including COP issues as part of master lease agreements?

Section II

Oral Testimony



Public Hearing

On

COPs in California:

Current Issues in Municipal Leasing

Oakland, California
June 18, 1992

SECTION II

ORAL TESTIMONY

Closing Remarks

COPs IN CALIFORNIA: CURRENT ISSUES IN MUNICIPAL LEASING

Hearing of the California Debt Advisory Commission
James Moore Theatre, Oakland Museum
1000 Oak Street, Oakland, California 94607
June 18, 1992
9:00 a.m. to 1:00 p.m.

FINAL AGENDA

I. OPENING REMARKS

State Treasurer Kathleen Brown

II. BACKGROUND ON COPs

Henry Gardner, City Manager of Oakland

John Pizzarelli, Representative, Association for Governmental Leasing and Finance

III. ABILITY AND WILLINGNESS TO PAY

For California Issuers in General

David Brodsly, Vice-President & Manager, Moody's Investors Service

David Dubin, Assistant Vice-President, Municipal Bond Investors Assurance Corp.

Rafael Costas, Supervisor & Senior Research Analyst, Franklin Fund

Richard Hiscocks, Attorney, Orrick Herrington & Sutcliffe

Stan Wolcott, President of the California Association of Bond Lawyers

Richmond USD & School District Use of COPs

Stuart Greenfeld, Manager, Office of Financial Management Practice and Standards, CA Department of Education

Thomas Duffy, Superintendent of Moorpark USD & Past Chair of the Coalition for Adequate School Housing (CASH)

Sandra Lemmons, Representative of the California Association of School Business Officials (CASBO)

IV. ACCOUNTABILITY TO THE PUBLIC & INVESTORS

Barbara Lloyd, Assistant Vice President, Leifer Capital

Kent Taylor, County Administrator, Santa Barbara County

Dr. Arthur Katz, Audit Chairman, Nevada County Grand Jury

Suzanne Finnegan, Managing Director, Financial Security Assurance

V. COST-EFFECTIVENESS OF COPs

Jeff Thiemann, Director, Standard & Poor's Corp.

Murphy McCalley, Finance Director of San Diego MTDB

Russell Lombard, President, Transocean Funding

Robert Williams, Vice-President, Sutro & Company

VI. PUBLIC TESTIMONY

COPs IN CALIFORNIA: CURRENT ISSUES IN MUNICIPAL LEASING

Hearing of the California Debt Advisory Commission
James Moore Theatre, Oakland Museum
1000 Oak Street, Oakland, California 94607
June 18, 1992
9:00 a.m. to 1:00 p.m.
Kathleen Brown, State Treasurer
Chair, California Debt Advisory Commission

Brown: My name is Kathleen Brown and I am the State Treasurer and Chair of the California Debt Advisory Commission, a commission that was recently rescued from obliteration in this year's budget hearings and we are here today to hold a hearing on the issue of Certificates of Participation (COP) and their use in California. I have dubbed this hearing "Good COPs--Bad COPs" and hopefully, by the end of the day, we will have a sense of what is a "good COP" and what is a "bad COP." I want to thank you all for coming here today and; as I said, the subject of our hearing is certificates of participation and other kinds of lease-backed municipal securities in the State of California.

As you all know, COPs have become big business in California. They represent the largest single type of public debt instrument issued in our state. Last year, local public agencies in California issued $5.1 billion worth of COPs, an increase of over 70 percent from the prior year. While much of this increase represents a low interest rate environment--which is favorable for refunding--there have been, nonetheless, $5.1 billion in COPs and that is still a pretty big number.

By way of comparison, local agencies in California issued only $623 million worth of general obligation (G.O.) bonds last year, roughly $1 in bonds for every $8 in COPs. The reason, as most of you know, that COPs have become the biggest debt instrument of choice for local governments in California, is that they are not a debt instrument at all. They may look like debt and walk like debt, but COPs are legally structured as lease-purchase agreements. Yet virtually any public facility that can be financed through municipal bonds can also be financed through COPs.

The added advantage of COPs is that since they do not legally constitute debt, they are not subject to the constitutional and statutory restrictions that apply to debt; the most significant one being the two-thirds vote requirement for local G.O. bonds that typically would be used for government investments in infrastructure.
It used to be in California that these investments were partly financed through property taxes, but with the passage of Proposition 13, which I understand has been affirmed by the Supreme Court this morning, local governments have had to find ways to finance their infrastructure to meet the state's explosive growth.

As we learned at CDAC's recent hearings on the Mello-Roos Act, land-backed securities are one way to cope with jammed freeways, crowded schools, courthouses, and jails which are bursting at the seams, and a host of other problems that can only be solved by investments in infrastructure.

Another way is through certificates of participation. I've heard from many of my colleagues in local government, who say they wish they had reasonable alternatives to issuing COPs and thus this hearing is prompted by concerns that they have brought to me.

Ideally, they would like to address more of their capital facility needs through G.O. bonds. The reason is that most COPs are supported only by the general fund of the issuing agency. Consequently, the agency must cut back in other areas of its budget in order to pay the debt service on the COPs. By contrast, local general obligation bonds would generate an additional source of revenue to pay the debt service. Yet, mounting a campaign to win public support for local G.O. bond measures requires a substantial commitment of time and resources only to face the prospect of likely defeat due to the two-thirds vote requirement that gives every "no" vote twice the weight of a "yes" vote. This anachronism, which has its origins in the unstable financial markets of the late 19th century, exists in only three other states: Idaho, Missouri, and Oklahoma. By contrast, the State of California itself can issue G.O. bonds with only majority vote approval, but State G.O. bonds, as you know, do not provide any new source of revenue. Thus, to pay off the debt service for State G.O. bonds, we must take dollars from other programs in the General Fund. Consequently, the two-thirds vote requirement is the *Maginot line* of public financing in California. It does not stem the flow of public financing as much as it channels it towards COPs and other forms of lease-backed financing.

Ideally, local governments would rely more on G.O. bonds, the most secure form of municipal debt, and less on COPs, but as long as the two-thirds vote requirement remains in place, my view is that local governments have no choice but to consider tools like COPs. At the same time, however, we must recognize that the difficult economic times we are experiencing require more vigilant financial management practices at all levels of government. It's our responsibility, as those entrusted with public resources, to prepare for the worst and it is coming.

We will hear a lot today about the default of the Richmond School District on a $9.8 million COP issue. In fact, we invited the principal players in the Richmond lawsuit to address this hearing, but we understand that the pending litigation makes it difficult for them to participate. While many of the factors leading to this default were unique to the Richmond District, it is true that many school districts across the state are facing financial difficulties. I expect today that we're going to hear from representatives from local governments, not simply school districts, that are going to be facing extreme financial hardship, particularly cities and counties, if the State Legislature shifts the burden for financing many of the local services back to the local level.

The uncertainty that surrounds our State budget situation has already had an effect on the Los Angeles Unified School District, whose certificates of participation and leases, just a day or so ago, were put on Credit Watch with negative implications by S&P (Standard & Poor's).

It's not unreasonable to assume that the Draconian State budget cuts, which I referenced earlier, to education and other programs now being considered, could further exacerbate, not only the Los Angeles situation, but for school districts and localities across the state.

The prospect of future "Richmonds" makes this an opportune time to examine the issue of the State's liability for school district COPs. At the heart of this issue is a fundamental imbalance between funding responsibility for school operations, which rests largely at the State level, and the authority to borrow funds, which rests with the local district.

One of the peculiarities of this arrangement is that when school district borrowings go awry, people naturally look to the State to foot the bill. A status quo that separates financial liability from decisionmaking authority cannot persist indefinitely. Through legislation or the courts, the State's liability will either be limited or it will assume more control over local borrowing decisions.

Thus, one of the topics we will hear about today is going to be the Assembly Bill 1200 program, which is being implemented by county boards of education throughout the state. Under this program, school districts which cannot meet minimum criteria of financial solvency cannot issue debt without approval from the county superintendent. If successful, this program might offer a reasonable middle ground between stronger State control and completely unfettered local borrowing.

Let me conclude by stating that I am open, at this hearing, to receive a wide variety of perspectives today. That is the reason we are here. There is certainly room for reasonable people to disagree on the proper use of lease-backed financing and, hopefully, we can avoid the polemics which sometimes obstruct true public discourse in the state. Because what is at issue today is unbelievably important. It is nothing less than how we will finance those public facilities; the schools, the roads, and the infrastructure that are needed for a prosperous economy in California in the years ahead.

We've invited a list of very knowledgeable speakers to address the issue of COPs in California and if there are others in the audience who wish to speak, we have a list and Janae Davis, if you would stand up so people know where you are and who you are, you can sign up with Janae and we will have you speak after the formal speakers.

The hearing will be recorded and we are also accepting written comments. Mary Scharosch, if you'd stand up over here, anyone who has written comments for our report, please give them to Mary as you come up to speak or following your remarks. They will be published in our official report.

I want to introduce our Commission members who are here. We have with us today, David Woods, representing Controller Gray Davis, and we welcome you. We have Treasurer Don Merz, who is a member of our Commission and we have Steve Juarez, who is the Executive Director of the Commission.

With that as an introduction, I, again, want to thank all who have come to participate today. As I recall from our Mello-Roos hearings, everyone kept their remarks to the five-minute limit. We were able to conclude that hearing on time. This hearing is scheduled to conclude at 1:00 p.m. and we would be pleased if we concluded it on time or earlier.

So let us begin with speakers who are going to give us some background on certificates of participation. We have provided handouts and a background paper for you. These charts can be found in the background material. They provide, I think, some summary information. But to address the issue of COPs from a background perspective, is someone who knows, probably as well as anyone in this room, how important they have been as a financing tool. I would like to introduce and invite to speak to the hearing today, Henry Gardner, the City Manager of Oakland. Henry...

Gardner: Thank you very much. Good morning and welcome to the City of Oakland and welcome to this crown jewel of the City, the Oakland Museum.

I did not really think very much about why you chose to have this hearing in this facility until I sat down and then it occurred to me that there was some financing related to this facility that may have had something to do with the motivation for selecting it as the site and that is, indeed, appropriate.

Shortly after the passage of Proposition 13, the City looked across the way at the building roughly adjoining this one, the Oakland Auditorium, which was built in 1915, and recognized that we had a $15 to $20 million construction problem. The State was threatening to close the building down. It had very high usage by members of the public. The City had lost about 25 percent of its revenues and the City was faced with the daunting task of how we would raise that kind of money in the face of our own budget shortfall and continue the building in use.

We struggled with that question for some time and after about a year or so of trying to figure out a way to finance it, we settled on a proposal to sell and lease-back, not only that facility, but also this one. The result of that was an opportunity to do several things. One was to rehabilitate that building and restore it to its former use. We were able to establish--from some other funds that we had, that we would have put into the maintenance of this building--an endowment for the Oakland Museum to provide for some of the ongoing maintenance. We just recently refinanced the debt on the museum and that generated $1.5 million to the City.

I would argue that the first reason for issuing COPs, or any debt, is that there should be a valid need for doing so. If there is not a valid purpose, then the debt should not be issued. Secondly, there has to be a clearly defined method for repaying the debt. I think one of the reasons that some jurisdictions have gotten into trouble by issuing COPs is that there never was a sound source of repayment to begin with and I think that it is a mistake to simply substitute one financing problem for another and to hope that by borrowing, that something good is going to happen in the future and you're going to meet your debt obligations. So I think first, there should be a clearly defined purpose and secondly, there should be a clearly defined revenue source to pay it.

COPs are easier, mechanically, to issue than general obligation bonds. I would remind the Commission and the audience that for over 10 years, general obligation bonds were not possible in the State of California because of Proposition 13, even with two-thirds voter approval. General obligation bonds require the pledge of the full faith and credit of the issuing jurisdiction and, under Prop. 13, it was not possible to do that. A general obligation bond says, literally, that the jurisdiction will raise taxes to whatever amount is necessary in order to meet the obligations. Again, that was not possible until a few years ago following Proposition 13.

It is part of the city and state and school district financial crisis that led many jurisdictions to look at certificates of participation. I would say, though, that even if that were not the case, we have an ongoing responsibility to identify the most cost-effective means of financing capital equipment and infrastructure building and repair. In some cases, it is more cost-effective to borrow on a long-term basis than it is to go on a pay-as-you-go basis. Also, pay-as-you-go basis frequently has not provided the public to take on major capital improvements. Those were historically done by general obligation bonds and they were also done when cities and counties and school districts were a lot healthier financially.

I think that some of the issues that we need to also consider is whether or not we can issue debt of any kind without jeopardizing higher priorities of the jurisdictions. If revenues are not stable and the obligation is still there to pay, if it means that the certificates of participation are going to end up coming ahead of higher priorities of the jurisdiction, that needs to be carefully considered before that debt is issued.

My time is already up and so I would just summarize by saying that I think that first and foremost, we have to look at how cities and school districts and counties are financed. What are the permanent, reliable revenue sources that we have to provide public service? The State, while we sit here, is contemplating doing some very unpleasant things to local government and school districts. Unlike Proposition 13, we had about three months to prepare for its passage. We knew that if it passed--and we knew that there was a high prospect that it would pass--we knew precisely what would happen to us; what our loss of revenues would be from property taxes.

Here we sit on June 18th; there is high probability that the deficits of school districts and cities and counties will double, based on what happens in Sacramento. We don't know when it's going to happen. We don't know how badly it's going to hurt. And yet we hear elected officials and the public saying that they don't want to raise taxes; they don't want to close libraries; they don't want to close fire stations; they don't want to stop street sweeping--and that's not real.

As we struggle through this, as professionals, we have a responsibility to make the message loud and clear: that doesn't work. And substituting one problem for another doesn't work; and if we do not have a reliable source of revenue, if there is not a strong likelihood that we can repay the debt, we shouldn't issue it. Thank you.

Brown: Mr. Gardner, we have some questions for you. Do any of the Commission members have questions for City Manager Gardner? Mr. Woods? Treasurer Merz? Let me ask one, if I may. Do you think that there should be thresholds established for local governments with respect to lease debt as part of some kind of local debt management plan or do you have such a debt management plan?

Gardner: We do and I think that setting thresholds makes sense. I think that it would address the very problem that is before the Commission today and that is: How much debt is too much debt? I guess that is the question and I think having some thresholds set based on some rational basis makes sense, because right now that is not clearly defined.

Many of us rely upon the rating agencies to say, "we do not believe that your portfolio is well constructed." One of the thresholds that we use is that unless our debt has a minimum of a solid "A" rating, we don't issue it and you can't get there unless you can convince the rating agencies that you have a reliable income stream to meet that debt. But we don't have a dollar amount that we have set.

The other is that we don't issue debt unless we are issuing it for a high priority city service, which means that as we face budget shortfalls, right now, that debt would still be a higher priority than some of our other city services.

Brown: And with respect to your City's overall debt, what would be the ratio of G.O. and lease-backed debt as a proportion of your general funding?

Gardner: Like most cities, we have very little general obligation debt outstanding. We have issued two, actually only one, very small general obligation bond of about $10 million last year and that was, obviously, with voter approval. Our older general obligation bond debt has all been retired. Most of the debt that the City has outstanding is certificates of participation.

Brown: Do you recall what ratio the debt service is to your general fund revenues?

Gardner: I don't. Maybe my Finance Director can help me. He's sitting in the audience.

Oakland City Finance Director: It's about five percent.

Brown: That includes all lease-backed? So, it's within the five percent rule of thumb that the credit rating agencies utilize. Would you or do you support the constitutional amendment that is numbered ACA 6 that has been introduced by Assemblyman Jack O'Connell and Senator Becky Morgan that would reduce the two-thirds vote requirement to a simple majority for general obligation bonds at the local level?

Gardner: Absolutely. I think it makes no sense that one third of the voters can deny the rest of the voters the opportunity to set priorities and finance important services like improving our public schools.

Brown: And if you had that simple majority, would you see your jurisdiction turning more to the general obligation bond financing?

Gardner: I think there would be more reliance upon general obligation bonds. I think that there is a fair amount of consensus that most of us would prefer that voters approve the debt that we issue and that they stand up and say that they're willing to be taxed in order to pay for it. But two-thirds voter approval, I have always thought, is unreasonable and it has blocked many cities from going to the voters because it is very difficult to get.

Brown: Very good. Thank you very much, Mr. Gardner. The next speaker is John Pizzarelli who is representing the Association for Governmental Leasing and Finance. I have to step out for just one moment. I'm going to ask Mr. Woods--if you would carry on the agenda--and I welcome you.

Pizzarelli: Good morning. Before starting, I'd just like to say that leasing is an important tool, but it is not a panacea, nor the best financing approach in all situations. The Association feels strongly that it should be used wisely and consistently.

We were asked four questions today and I want to go through them one by one.

Our first questions is: In addition to the Richmond School District default, what other events in the U.S. impacted the lease market in the past year?

Well, I'd first like to say that it really has been the last 15 years that has the greatest influence on the leasing market, although there has been some change in the last year. We have to keep that in mind the perspective on this. Certainly, the current economic recession has had a tremendous influence on local government and has concerned some investors across the board in municipal finance. Some investors are questioning the ability to pay. In certain areas, for the first time ever, that has come to be a concern.

Other areas that the willingness to pay is being questioned on the leasing side is Brevard County, Florida, where after financing an office building, the county commissioners seriously considered going to a voter referendum after the fact. Another example is Florence County, South Carolina where the commissioners of the county felt that the scope of the project was too large and the lease rental payments were too much and they considered not paying.

There was a situation in Capital City Leasing Corporation in Texas, where an authority--a solid waste authority--no longer needed landfill equipment and it nonappropriated. The interesting part about this case, and it was heard in the City of Austin, was that because of a "best efforts" clause within the lease, they felt that it became invalid and unconstitutional debt. Any Texas lease that has that language in it, the lessee has the right to walk away.

Another example is the Northern Virginia Transportation District where a Supreme Court ruling basically froze leasing altogether. Later on they went back and they reversed that decision.

Before I go on, I just want to say that the market, the total market, exceeds $12 billion. We have to expect a few problems, but most leases are problem-free. And we have to keep that in mind.

Second question: Has there been a substantial increase in the spread between G.O.s and leases in the past year?

The basic answer to this question is: not really; although it does depend upon what day you go into the market. About three years ago, there was roughly a five basis point spread between G.O.s and leases. When Brevard was at its peak last fall, and the fact that spreads were widening in general, the spread between G.O.s and leases was about 30 basis points. Today the spreads are between 20 and 30. So we, the Association doesn't feel there has been a substantial increase; although if investor confidence begins to decrease, that could change rapidly. Some traders I have been talking to in the last few days have said that some trust funds are backing off on COPs, particularly on the short-term, five years and under. There are some buyers that are second guessing school districts in California, but this is not a wide spread problem, so far.

Third question: Does the marketplace continue to place a price distinction between California COPs and leases sold in other states?

Well, we think it's real difficult to compare a California COP to, say, a lease revenue bond in Indiana or another COP in another state. It's like comparing apples and oranges to some degree. There are so many variables like market demand, key lease provisions, essentiality of the asset, and the lessee's payment history; but if you looked at it purely from a security standpoint, California's COPs are near the top of the list--maybe ranking Indiana number one only because once the project is completed and accepted, there's a continuing pledge of unlimited ad valorem taxes.

The fourth question: Looking to the future, what are the leasing industry's greatest concerns when it comes to California COPs and what can be done to address these concerns?

Far and away, we feel the biggest problem is that the problem leases could get blown out of proportion and negatively impact the good leases--almost like a spreading poison. And that is a concern for all of us in the Association. Certainly, the ability to pay, as I said earlier, because of the recession and states having their budget problems that is filtering down and straining local governments. But we do feel, as the recession ends, many of these concerns will dissolve.

And, finally, I'd just like to say, because of the concerns I mentioned, but also regardless of them, we urge that leasing be undertaken in a responsible manner by all parties; it be used for essential purposes; and that lessees take their commitment seriously. Leases can be win-win situations for all parties, and this happens most of the time.

Woods: Well, thank you Mr. Pizzarelli. Any questions of Mr. Pizzarelli?

Merz: I might just ask if--this question was asked before--if you have a feeling as to a particular level of debt that's reasonable and whether you feel that there should be standards set along those lines?

Pizzarelli: Not speaking for the Association, but my own personal opinion as an analyst from a credit enhancement company. We look at COPs as debt, just as the rating agencies do. Aside from differences in risk perception and having to look at the asset in a lease case, we look at the total level of debt including leases, so it really doesn't make much of a difference what the balance is or the mix between G.O.s and COPs are, from our perspective. Any other questions?

Woods: I had a couple coming from your testimony, Mr. Pizzarelli. You mentioned the comparison of California with other states and you mentioned Indiana. I was just wondering about that; is this because of the land values here--and I'm thinking in a more macro sense, not relating to COPs? For example, the Presidio in San Francisco--when that became open, and I understand it is the City now that has that or it's being transferred back from federal government. Is that the reason why California is so unique, because of the land values or other reasons?

Pizzarelli: I don't believe that's the reason, although it does come into consideration at times. Really, after you get outside of Indiana and California--California with the covenant to budget and appropriate--almost all the leases are either renewed annually or can have an annual appropriation out. The abatement risk itself, in California, with that legal provision, most analysts--and the rating agencies certainly feel this way in terms of the difference they rate between the G.O. and the COPs in California--feel it's a better security provision. The asset always plays an important role, but in my opinion, it's not because the assets in California are superior to other assets around the country, necessarily.

Woods: Then you would identify the process of the covenant to budget lease payments--the security provision itself.

Pizzarelli: Yes.

Woods: Another question I had in just reading through the background material, I'll just address it to you. In terms of these bad leases--the ones that have gone sour--is there any recommendation or view you would have to regulate them at the source? Would that be something that would improve your credit enhancement review? For example, a sign off the AB 1200 provision or some similar provision--I was just discussing with Mr. Merz, before we started, perhaps the county auditor or some entity or independent elected official making findings or passing on the leases before they're actually authorized?

Pizzarelli: That would certainly be helpful.

Woods: Do you have any recommendations, any models in other states?

Pizzarelli: Let me go on for a second. We do try to make sure there's proper authorization at the highest level possible before we underwrite a lease at MBIA. But I've got to tell you that the thing that is difficult to assess is the political willingness which can change over time. So you can do everything right, right out of the gate, and then three or four or five years later, things can change. And no matter how careful you are, no matter what steps or procedures you use in the beginning, there's no way of telling what could happen as time goes on.

Woods: Very good. Thank you. Any further questions, Mr. Merz? Thank you. If we could move on to, I think we're now under the subject of ability and willingness to pay for California issuers in general. Mr. David Brodsly, Vice-President and Manager of Moody's Investors Service. Welcome, Mr. Brodsly.

Brodsly: I'm going to try to limit my remarks to the questions I was given as well--we are doing our homework. You try to get your hands on what the trend is, if there is any shifting going on with COP issuance. The shifting in finance in California has been like a 50-year process, going back to the Offner decision of '42, away from sole reliance on general obligation bonds secured by taxes to a variety of instruments. Leases are a part of that shift. Prop. 13 clearly accelerated it, putting more pressure on resources, and the pressures on the general fund get addressed though leveraging through COPs. It's the only way of doing any borrowing using the general fund.

It's not simply a shift from G.O. debt to leasing. It's also a shift from pay-as-you-go financing to leasing as the leverage of the general fund has to be done through some fashion. You see that in equipment financing, probably more clearly than any other kind of financing.

Population growth and capital needs are a factor in the growth of COPs, but there's a whole slew of other issues. There's the downloading of responsibility from the federal and state government to local agencies. There's the mandated service levels in healthcare and prisons; and there's this general overall backlog of capital needs that have to be addressed in some fashion. For many capital improvements, the only tool available to them, short of pay-as-you-go appropriations, are COP financings--lease financings.

We've seen uses of COPs for non-lease purposes or nontraditional lease purposes. You see them in revenue financings now for the same reasons you saw them in

COP financings, which has to deal with legal limitations on bond law. In this case, it's typically the statutory limitation of revenue bonds. We've seen new uses of COPs as interim financing and in your position paper you addressed that question for financing in anticipation of reimbursement from state bond funds. You really have only one option which is COP financing. A grant anticipation note, to be rateable, has to have an irrevocable contract behind it. That is rare for all grants these days and we've never seen one for school pooling grants. So if you have that program, you are going to have COP issuances as advance funding for it.

You've asked how we evaluate lease debt. Notwithstanding that the word debt has very specific narrow meanings within constitutional debt limitations, we analyze all lease-purchase contracts as if they were a debt of the governmental entity. We include it in the totals for tax-supported debt. We use those totals for our debt ratios in our analysis. We include in that analysis all capital leases, which includes vendor leases and other third party leases, whether or not those leases have been securitized, presuming we are aware of the existence of those leases so we can include them in the totals.

We add to our analysis the lease--one that takes into account the maximum annual lease payments that are being projected as a percentage of general fund revenues and we get what we call peak lease burden. We've already started discussing what that magic number is. We don't have a magic number, but we find that peak lease burden in the six to eight percent of general fund revenues is still within the moderate range of lease burden, all things considered.

You've inquired as to whether or not we're seeing issuers over-committing their budgets to leases. We're not really. We see most issuers proceeding cautiously, financing primarily essential projects and remaining within that 6-8 percent range. We're seeing some issuers that are pushing those ranges in an attempt to earmark specific general fund revenues internally to make the lease payments that are not legally pledged, because they're general funds, but in their own budgetary management, they've identified funds which we would take into account in our evaluation of a credit.

We have seen some pressure, probably most notably in the area of hospital financing programs for counties. Those are large programs and can put immense pressure on a budget if they're financed through leases. There have been two downgrades in California that were, in large measure, a result of those kinds of programs, but other counties are doing quite well and managing their lease burden.

Turning specifically to schools, we don't really evaluate school leases significantly different than other leases. They're about 20 percent of the issues that we rate in COP and lease financings and about eight percent of the par amount. They do, obviously, have very unique pressures relative to how they can meet their fixed obligations, but that's the key distinction. They're not viewed as a totally different animal than other kinds of leases.

In addition to looking at the ability to pay, we, of course, look at willingness to pay and that has to be the most difficult of the rating factors we have to evaluate. There are some objective features we look at. We look at the lease schedules. Are they amortizing their debt quickly? Are they stepping up to lease payments quickly? We look at past performance. We look at the nuances of the legal documents. Are they attempting to provide maximum security to the investors? Are they looking like they are hedging their bets in some fashion? Equity contributions of cash or land are evidence of willingness to pay. Essentiality of the project allows us to infer a willingness to pay. It's not objective, but we can make a pretty strong inference. We make a distinction between real property and equipment COPs, in large measure, because of our evaluation of the essentiality of the two kinds of assets.

The other feature on willingness to pay is the "smell test." We look at financial management. We look at their sophistication, their awareness of the consequences of a failure to make the lease appropriation on bond ratings and on market access. In Brevard County, Florida, we were prepared to downgrade them for a failure to appropriate these payments and downgrade them in all their tax-supported debt, not as punishment but because of evidence of a lack of commitment to their long-term obligations.

And in closing, there are a couple of things on Richmond I'd like to specifically comment. I think that the defendant's answer in that litigation has created rather unnecessary turmoil, and the sooner that the defense can be reined in, the better it will be for local issuers trying to fund essential public activities.

Brown: Could you just elaborate on that?

Brodsly: The Board of Education's defense went to the constitutionality of the lease and threw a great deal of sand in the eyes of those of us who have to evaluate the creditworthiness of leases in California. We're still rating leases; we're still rating asset transfers; but that litigation does raise questions that, until it is reined in, will remain and will be part of the landscape for anybody who's looking at leases these days.

The known events of defaults, and I'm sure other people will mention this, in California leases are very rare. I know three and two of them are over five years old. The Lassen Community College and the Ventura Port and then with Richmond Unified School District--none of these were typical COPs for typical purposes; none of them we rated. We specifically declined to rate Richmond Unified School District, and downgraded their outstanding G.O. bonds, in large measure because we felt that that transaction was an inappropriate use of debt financing or lease financing.

To conclude, at the risk of sounding self-serving, I think the fact that the rating agencies do include lease transactions in the scope of their debt analysis and that most lease transactions have been reviewed and their securities have been rated by the rating agencies, does, in and of itself, provide a significant degree of accountability for leases and is a factor that accounts for the remarkable success of the instrument in California. And with that I'd like to leave you a moment for any questions.

Brown: Are there questions from Commission members? Mr. Woods.

Woods: I have a question, Madame Treasurer. Mr. Brodsly, you suggested in your testimony that you do rate COPs that are used for general revenue purposes. Did you say that?

Brodsly: No. What we do see is COPs that are secured by pledged revenues--special fund COPs, in lieu of say revenue bonds--COPs for sewers, COPs for trash of paid by trash fees.

Woods: Is there an instance where you rate COPs for just the general operations of the district or locality?

Brodsly: We have never rated a COP that was used for "working capital operations." We have rated COPs, if properly structured and secured for noncapital acquisitions, for funding liability management and self-insurance programs. Typically those have been secured by asset-transfers.

Woods: Would you rate a COP for working capital purposes?

Brodsly: I doubt it. It's hard to say for sure what one would do given facts, but it's hard to imagine a COP, a long-term obligation that we would rate to fund short-term working capital needs.

Woods: This is very interesting because we deal with rating agencies in another authority a lot and I know much of what you folks do is real vague, on the margins. So this is of interest to me, particularly, because I sit on several of these authorities. But it seems to me that there is some need or there would be an occasion that you would have to rate a COP for working capital needs in a given situation and the given jurisdiction might be able to support that because they either have room in their tax base someplace, the asset is particularly strong, the management--all these things that you pointed out. I'm just trying to probe you a bit on that. Is there ever a case where you might do that?

Woods: Well, my experience with the rating agencies is more as an issuer, myself, than an analyst and I know that as an issuer, I too, was always trying to test the lines as to what was normal practice. It's hard to draw a hard and fast rule. If we had a specific set of facts, it would be easier to address it. Generally speaking, one does not look to long-term debt to finance short-term operating needs. But I can think of examples I am aware of outside of California--I can't think of any examples in California--where there have been ratings in which... Let's say back East there's deficit bonds where governmental entities get themselves into a deficit situation and are restructuring their government, and they're trying to, as part of that restructuring, take some of their deficit out over a long-term period through debt. I am aware of securities of that nature being rated. I won't tell you they have been necessarily favorably rated, but there have been ratings in instances like that that I am aware of.

Woods: When you decline to rate an issue what do you do? Do you write them a letter? Do you broadly disclose it anywhere?

Brodsly: I guess the question--it's typically more of a question--is that we make it clear that the rating that we would assign is probably... We'd try to indicate where we're going with our rating, and more often than not, technically the request for rating is withdrawn.

Woods: And is that noticed anywhere? Do you put a letter in?

Brodsly: No. I think various counsels, we will hear from other lawyers who should advise you on this, probably have opinions as to whether or not there's a disclosable event that has occurred if something like that has happened, but we don't take that as part of our charge.

Woods: Is that something you'd support as, perhaps, maybe as some legislation? Something to regulate or give further disclosure in these bad COPs situations?

Brodsly: Well, again, we don't see bad COPs as being an endemic problem, so that whether or not there's a legislative need to address limited problem is something that I don't really think is our domain to address.

Woods: Would you object to some legislation, for example, that said something to the effect that once a rating is given to you and you decline the rating you have to actually issue a letter and that letter goes into the official statement or some such thing?

Brown: Actually, I think that the market--herein lies the nub of the issue--the market looks at an issue, and if it's not rated, it should speak volumes to the investors, and the marketplace assigns a price and a premium to that instrument because it doesn't have a rating. If it doesn't have a rating, you're going to get a higher yield. The issuing entity is going to have to pay more for it and, therefore, those who end up with an unrated piece of paper that goes into default have the security that is provided for in the documentation--and it is a system that works. If there is a default, somebody pays the price and the issue is, I think, the marketplace doing their due diligence.

Brodsly: And part of which, we would argue probably self-servingly, is getting a rating and having an independent rating agency review that and give their opinion. A rating that has been applied for and withdrawn, there could be a number of factors.

Merz: Do you have any suggestions from the rating agency on how we may put tighter controls on ourselves, as Mr. Woods suggested to the last speaker, we could improve that situation?

Brodsly: Well, again, I think our perception is that leasing has worked pretty well, in general, and that the only negative we currently see is the cloud of potential litigation that raises questions that are hard to see through until the litigation has been resolved. But up-to-date, we've had a fairly stable environment. Local governments are under tremendous pressures and the difficulties at the State level filtering down to the local level--which has already been strained without the states having its problems--clearly puts pressure on local credits and I'm afraid that's a bigger problem than I am really prepared to give you any solutions for.

Brown: Let me follow up on that a little bit. I think one of the issues, given the state and local governments financial difficulties today, will be if there are other defaults, is it in the State's best interest from a credit rating perspective to bail out the local entity or is it in the State's best interest to let the local entity pay the piper and go their own way. From a rating agency perspective, how do you view the State going in and rescuing a local entity or staying out?

Brodsly: That would change the ecology of local government finance in a somewhat significant manner if local agency debt became, in effect, moral obligations of the State. In some ways that would strengthen local governmental credits and in some ways, arguably, would weaken the State's credit by the State effectively assuming larger liabilities. I think in some ways that's a zero-sum game, and some credits are advantaged and some credits are arguably disadvantaged.

Brown: If that became a pattern of behavior, or if there were legislation that said that the State should move in or if the court says the State has to move in, would the State then be subject to the so-called weakest link theory of rating, wherein the State's rating would then be held to the lowest municipality's rating?

Brodsly: That's probably an extreme conclusion and I don't know that it would get to that. In the absence of AB 1200, I think the answer would have been different than it is today. With AB 1200, you have a defense mechanism. I think school districts are probably the State's biggest concern relative to the nexus between the local and the State level, and AB 1200 sort of addresses that head on. So if the question is, does the feature of the State bailing out the Richmond situation create broader, huge implications, I think, and this is a first impression, that AB 1200 probably insulates the State from that kind of conclusion.

Brown: So that kind of mechanism, the defense mechanism, as you described it, of AB 1200, does provide some measure of greater comfort to the rating agencies, vis-a-vis local issuance and the State's relationship to it?

Brodsly: Yes, I think it does.

Brown: On a slightly different topic, the issue of COPs or other asset strips for financing of debt at the local level, the distinction between operating cost and capital cost is fairly clear. But the distinction between capital expenditures and some of the other kinds of programs that are financed that are nontraditional, such as judgement liability bonds, the self-insurance bonds that you mentioned--can you comment on how you view those?

Brodsly: You really have to look at those on a case-by-case basis. There is no standard template you can apply. Typically they're very different. They don't come out all looking alike and I think that the real test is: Is it a rational method of solving a specific need of an entity? Are they effectively trying to do a shell game with resources such that they're effectively freeing up capital for operating purposes by just reshuffling their liabilities, or is there really a conscious program to better manage those liabilities in a rational fashion in a way that allows them to keep the normal course of operations going over the long haul. It's a long-term view. I'm most familiar with financing judgements. To the extent that the judgement is overwhelming and beyond the reasonable range of current resources, financing that judgement over time was supported by both statutory, indirect authority, and just by common sense. If it's simply trying to use monies that are current year hits--taking that liability that is arguably a current year hit--and spreading it out so you free up resources that otherwise would have arguably been pledged to meet those liabilities, then its deficit financing. There's no magic formula that allows you to distinguish that. It's just a matter of looking at the context and exercising judgement and that's at least the way we do it where I work now.

Brown: I'm pleased that there's someone exercising judgement at a rating agency who has real life experience as an issuer. Thank you very much, Mr. Brodsly. Next is David Dubin, Assistant Vice-President, Municipal Bond Investors Assurance Corp. (MBIA). Mr. Dubin.

Dubin: I think for benefit of the audience here today, David Brodsly covered many of the topics that we look for when we're insuring a certificate of participation or a lease revenue bond, specifically in this state. Certainly, the primary difference between the rating agency approach and the insurance approach is that there is always the possibility that if we insure a certificate of participation or lease revenue bond issue, we may have to pay on it in the future. Thus, our criteria may be a little bit more stringent in terms of where we think we may have a potential loss in the future. So, we've always set underwriting standards so that we have a "no loss" criteria. Now, having said that, we consistently focus on ability to pay, willingness to pay, and within those groups, we're always looking to the underlying credit of the entity. We're constantly harping with the financial advisors and the underwriters as to the projects that are being financed under the lease basis. So that approach has not changed at all from the rating agencies.

What I think I would like to add is why, I think, we have derived some more benefit, or at least why we have a little bit more of an ease in terms of insuring certificates of participation in California. That's because the structure is what we consider to be very strong as opposed to the annual renewal or nonappropriation leases that we see elsewhere in the country. Up to the point in time that Richmond went into bankruptcy, internally, we always rated those deals better and that was because there was the covenant to budget and appropriate once the facilities were accepted. In order to mitigate that acceptance risk, we often structured our deals with the asset transfer because it eliminated the construction risk. Now with the goings on with Richmond, we have stopped underwriting asset transfers, but we still continue to underwrite COPs in the State of California at both the state and the local level.

After the acceptance of the facility, our primary risk is abatement. Now, abatement can occur for several reasons. Our biggest concern is earthquake risk. What we have done to mitigate that, and in order to better analyze it, we have hired a local firm called Dames and Moore, and we run all of our information concerning the project, including the building type and zip code, into a specific Fortran model which allows us to consistently judge whether or not an earthquake has the ability to pull down this facility. In the event that the facility does come down due to seismic risk, then there is a strong possibility that MBIA or another insurer would have to pay because rental interruption insurance--which is generally structured into these transactions, generally one or two years of rental payments--will not be honored. So once we move away from earthquake risk, and in some cases, flood risk, we think we have a very strong transaction.

Also, what we're looking for in the California COPs is the presence of the debt service reserve fund in order to prevent any timing problems. Because rental interruption insurance does not flow evenly, and it is possible that it could take three to six months for those actual monies to flow in, there is the possibility for payment from our policy and we're always concerned as to how we're going to recover monies in the future. But after you've looked at the ability and the willingness to pay, and you consider the type of the structure that's being presented in California, we think it's still a very safe security.

I would say that in the last year, due not only to the Richmond decision, but also the recession at the state and local level, we have been more stringent in our analysis; and it is not uncommon for us to turn down entities for a variety of reasons including financial distress, if these credits may have been approved in the previous year. So every lease is looked at on a case-by-case basis and sometimes our underwriting committee does not permit a lease with "x" municipality or "x" school district that was approved the year before to be approved again if they were to go into the market.

So, in sum, what I wanted to say is that we still are insuring certificates of participation in the state and we still feel that they are very valuable means for providing financing for needed public facilities of both the school district, city, county, and certainly state level. So, if there are any other questions, I'd like to answer them.

Brown: Thank you very much. Are there questions?

Merz: I think only along the lines what we've asked the other people--can your industry give us any ideas or suggestions that you would like to see occur that we could implement, that would make COPs stronger to you?

Dubin: Well, I think there is one thing that can be done and it has to do with the fact that even though COPs are issued without voter approval, I think we would like to see a municipality or the school district get the public more involved with the projects at the initial stage or several months prior to the actual financing. We feel that the more input there is from the public, then we mitigate the risks of a nonpayment in the future or voter uprisings, which is what we saw in Brevard County. So I think, to the extent that you involve the public, that makes it a stronger transaction.

Certainly, if there is additional oversight at the State level, such as what we see in New Jersey, whereby the county commissioners must approve every school district budget and insist that the lease payment is installed in the budget and it will be the last discretionary item cut, we find those to be significant strengths in the New Jersey lease transactions, which, by the way, are subject to appropriation and considered, on a relative basis, slightly weaker than California COPs, at least from our firm's perspective.

Brown: Let me just ask a question with respect to the security for lease debt. From your perspective, in a case of default, is the legal remedy of taking possession of the lease property realistic?

Dubin: It depends upon what you've financed. I would say that in many instances, the more essential the item that you financed, or the more essential it is to the daily operations of whatever entity that you're dealing with--if, for example, it's a city hall with a courthouse facility, there could be some problems gaining access to that facility through the courts because the alternative is to throw prisoners onto the street, and that's simply unacceptable. But the reason that we maintain a requirement for obtaining that leasehold interest is so that at least we can go to a court of law and say: under this particular contract, we have this remedy available to us, and to the extent that we can pursue it, we will. And if that helps the entity change its mind in its thinking on paying or not paying, then so be it.

Brown: Alright, well, thank you very much. The next speaker is Rafael Costas, Supervisor and Senior Research Analyst from the Franklin Fund. Welcome.

Costas: Well, good morning. As a buyer, we've been asked to address questions about the effect on COPs in California, especially given all the national news on the Richmond case. I'll go through these questions.

There has been negative press, and I was conferring with our portfolio manager who runs the California fund as to has he seen any effect on COPs in California. He hasn't really and Franklin hasn't seen much of an effect in the market itself. There are some people, obviously, like trusts and other buyers, that have become skittish and made a blanket statement: no, we're not going to buy anymore COPs; but I think, by and large, the largest buyers are pretty well staffed and they can still continue doing homework before looking at a deal and buying it. So where those people have stayed out of the market, there has been room for other buyers to step in.

In terms of the school districts, though, our portfolio manager feels, and that apparently some evidence bears his statement, that school districts by themselves, have suffered a little bit more of an image problem, in the case of the Richmond situation. And whereas COPs, school district COPs that are rated, he said are trading about 10 or 15 basis points lower than other COPs. The ones that are not rated are usually trading at 25 basis points higher and that goes on a case-by-case scenario.

We still purchase COPs. When we look at them, we do the same analysis we have done before. I think most buyers still do. There has been a lot of press here, and it does bring out other aspects of COPs to look at before making a decision, but our analysis remains the same. We'll look at essentiality; we'll look at the terms of the lease compared to the asset; and the ability and willingness to pay, especially in a time of recession when there is a lot of articles being written about some people having fiscal problems and they're going to have to make some decisions to cut back or not cut back certain items. They look at leases which legally don't have to make a payment as much as a G.O. We do look at them as debt and we do look at them as if they decide to default on a lease payment, their G.O. rating is going to suffer and market perception is going to suffer for G.O. debt as well.

The Brevard County situation was a good example of that last year, where as soon as they announced, they had people from the press calling, telling them the effects; they had buyers calling telling them of the effects; they had insurers calling and telling them; rating agencies as well. In the very end they decided not to go through with the nonappropriation.

In terms of what can we do, similar to the Mello-Roos problem, is something like AB 1200--increased reporting requirements. Buyers, and I'm sure rating agencies and insurance have the same problems sometimes, where the issuer loves you when you're looking at the deal and before you make a decision to buy because they need the money. Once they have the money and you call a year later to find out what's going on, as many times as not, you will have a problem in getting the right information that you are seeking. That would help a great deal to have secondary disclosure.

And finally, the last question that I have was: Will we all keep buying California COPs that aren't rated? We will keep looking at them. We will not turn any deals back just because they aren't rated COPs. There are very good ones out there who, for some reasons decided not to get ratings and we'll look at them with the same criteria we use to look at rated ones and we'll make a decision based on what we find out whether to buy them or not.

Brown: Good. Thank you very much. Are there questions?

Merz: No.

Brown: Next is Richard Hiscocks, Attorney with Orrick Herrington.

Hiscocks: Honorable Chair, members of the Commission. Thank you very much for inviting me to attend your hearing this morning. I am the leader of the public finance group at Orrick Herrington and work daily with state and local governments on tax-exempt lease financings.

For many years, California lease financing has provided a wide variety of important public facilities to California citizens, including large facilities such as state prisons and the Moscone Convention Center, and much smaller facilities such as school buildings and rural health clinics. The constitutional basis for lease financing dates back to at least 50 years ago in decisions by the California Supreme Court and has been repeatedly and consistently upheld since that time.

Today I have been asked to address four specific questions addressing the State of California's use of lease revenue bonds as compared to COP transactions by local governments and to comment on the authority to provide certain types of lease covenants.

The first question I was asked is: How does the process and structure of lease revenue bonds issued by the State of California compare with COPs issued by other public agencies in the state?

I've prepared a chart which I'll submit with my written comments, but it seems to show, based upon the 13 or so factors that I was able to identify, that on virtually all bases of comparison, lease revenue bonds that are issued by the State, principally through the State Public Works Board, are very comparable with certificates of participation issued by other state agencies. And just to provide a few examples of the factors that I looked at; those in which there was similarity, for example, are the following:

Is there an express bond statute or certificate of participation statute? And the answer is "yes" for the State, through the State Building Construction Act of 1955 and the answer is "yes" in most instances for local governments. Because of the amendments to the Joint Powers Authority Act in 1986 which added Article IV, the local bond pooling statute, most COPs today in California issued by local governments, in my experience, are done through joint powers authorities. Those joint powers authorities have express statutory authority, granted to them by the Legislature, to issue certificates of participation.

There are other instances in which local governments don't use their joint powers authorities and there the statutory authority varies depending upon the governmental unit involved. In both instances, the state and local government require express legislative approval. California not only has a direct appropriation by the State Legislature, but also an administrative review at the Public Works Board level in which constitutional and appointed officers must approve the bond issue. This is comparable to the city council or board of supervisors in the local government which are also required to approve COPs at that level.

Voter approval in neither instance is required. The one exception, interestingly enough, is for local governments where certain city charters, San Francisco being an example, do require voter approval of certain lease financings.

There is express case law allowing both types of lease payments at the state and local levels, both long-term and year-to-year leases. Title is vested in the governmental entity when the rent is paid off in virtually all instances. On structuring details such as interest rate limitations, there are none at either the state or local level. The securities in either instance can be sold at negotiated or competitive sale. Both types of securities offer the possibility of doing variable interest rate financings.

The holder of the trust funds for the State is the State Treasurer, acting on behalf of the State Public Works Board, whereas for local government units, it may sometimes be the local treasury, but more often would be a corporate trust department of a bank.

The maximum lease terms are all very amply provided for in State statute. Public Works Board bonds could be as long as 35 years and indeed some of the joint powers authority bonds, which the State has been involved in, could technically be as long as 50 years. None of the bonds, in my experience have ever exceeded 50 years. For local governments, the same is true. Fifty years is the maximum limit, although again I don't think securities of that length have ever been issued. The trustee for bond issues at the State level is either the State Treasurer or a corporate trust department of a bank and for local governments, of course, it is always a bank.

The one ingredient that is different, and it focuses on the issue this morning that we're exploring, about what makes a lease financing better than another, is that the State Public Works Board statute, due to amendments enacted by the Legislature in 1986, requires a state agency that leases facilities from the State Public Works Board, to allocate their first lawfully available funds...

Brown: Their first child.

Hiscocks: Exactly...in each year to make their rental payment. So before any of their other support items are paid, their payment to the Public Works Board is made. Now, comparable provisions could be entered into by local governments, although in my experience that hasn't been the case and that might be something that local governments would want to consider.

The next question I was asked is: Do you believe that the State of California has the authority to issue lease revenue bonds which are part of an asset transfer structure? And the answer is "yes." The State Public Works Board, on at least two occasions, has been given express authority by the State Legislature to undertake asset transfers. The Legislature has authorized asset transfers for certain prison facilities and for the financing of the then proposed California site and improvements for the Superconducting Super Collider, a project that, unfortunately, is now being built in Texas rather than California.

In each of these cases, the Legislature authorized asset transfers for different reasons. Asset transfers, I believe, can be a very effective means of funding needed public improvements that are the subject of special circumstances that might make a traditional lease financing inappropriate. For example, such special circumstances might include the limitations on who is allowed to own the financed project. Another special circumstance, might be the need to adapt the lease financing to accommodate the special factors surrounding the asset being financed, such as a wheelchair ramp or guardrails or handicapped access facilities or fire safety systems.

Next, I think it's important in the asset transfer context to think about the possibility of using asset transfers to address costly and ancillary delays that are sometimes caused with major projects due to design and planning issues or even, in some instances, litigation. And, finally, asset transfers provide certain issuers with the ability to eliminate the need for capitalized interest during the construction of the financed facility and in that way they can actually reduce their borrowing cost.

The third question I was asked is: Are there any instances where State-issued COPs would make more sense than lease revenue bonds? The Legislature, acting through the Public Works Board process, has provided a lease revenue bond financing vehicle that's been used extensively by the State for a wide variety of improvements: for higher education, correctional facilities, state office buildings, and even energy efficiency projects. However, occasionally, the State may wish to issue certificates of participation to finance capital equipment or projects that qualify for tax-exempt financing, but have not been authorized pursuant to the Public Works Board statute, and I'd like to give an example of when that might occur.

Equipment procurements, authorized by the State each year in the tens of millions of dollars for telephones and telecommunication and data processing equipment and sometimes for office facilities are not authorized by the Legislature to be done through the State Public Works Board process. However, by undertaking its own certificates of participation financing for such equipment or office facilities, the State may be able to potentially benefit by direct access to the capital markets. At the moment, by not issuing COPs, the State, as a practical matter, relies upon intermediaries, such as manufacturer's lease financing programs that may or may not reflect the lowest possible cost of capital to the State.

This situation is addressed in legislation, now pending in the State Senate, Assembly Bill 2 (AB 2) by Assemblymember Areias. AB 2 would authorize the State to issue lease revenue bonds through the Public Works Board for equipment procurements and, thereby, potentially reduce State capital costs below the costs of current procurement programs.

Fourth and finally, I was asked: Do you believe that statutory clarification is needed to address the issue as to whether California public agencies can provide covenants to budget and appropriate?

I think, because of the constitutional limitations--the debt limit in this area--it's necessary to break this question into two parts. First of all, the covenant to budget--to place the rental payment in the budget itself--and secondly, the covenant to appropriate--the legislative act to actually pay the rent pursuant to the terms of the lease.

First, a covenant to budget is based on the existing governmental power of the State or local government to provide, in their annual budgets, for the payments to be made under their contracts, including their leases. In rare instances, explicit statutory authority is provided. One example would be the one I mentioned earlier about the Public Works Board and the first lawfully available funds sort of provision. However, I don't believe that more legislation in this area is necessary because the power to budget is a fundamental power of government units and, perhaps more importantly, the covenant to budget each year's lease payment has been included in many of the leases that have been expressly approved by California's courts.

Second, I believe that analytically, an unqualified covenant to appropriate funds, as distinguished from budgeting them, could violate the constitutional debt limit. Providing for rental payments in a proposed budget is a ministerial act. However, the legislative act of actually appropriating funds is subject to the extensive rules set forth in case law establishing and interpreting the lease finance exception to our constitutional debt limit. For example, under a properly drafted long-term lease, a governmental unit must appropriate funds to make its rental payments, but only so long as it enjoys beneficial use and occupancy of the lease property. For example, if the use of the property is lost due to a casualty loss, no appropriation is allowed to be required by the lease.

Since the principles controlling the appropriation of rental payments are based upon court interpretations of the constitutional debt limit, I believe that legislative efforts to regulate this area by statute would be of limited benefit. Moreover, thanks to the many California cases expressly upholding lease financing arrangements, in my view, further legislation is not really required. I'd be happy to answer any other questions you have.

Brown: Very good. Thank you. Mr. Woods.

Woods: Just one question. Thank you, Mr. Hiscocks. I just wondered, have you handled any COPs for working capital needs?

Hiscocks: No, we've not.

Woods: Why?

Hiscocks: I'm not certain that we've been asked. Were we asked, based upon informal discussions we've had in our lease group, I don't think we would approve them due to the lack of the same sort of case law authority that I mentioned that uphold other types of California leases.

Woods: So I take it then you would be disable from writing a legal opinion that they would be proper.

Hiscocks: I would never say never, but I would have to say that it's not likely that we would approve such a financing.

Woods: Thank you.

Brown: Treasurer Merz.

Merz: Your firm deals with many levels of government, city, county, districts. You spoke that you didn't feel any additional legislation was required. Do you feel that there are any further controls, possibly based upon the type of government--as you see the structure, the size--any particular areas that need controls or some that you could make any suggestions along?

Hiscocks: I think that the suggestions I'd make are not legal recommendations. I think the law in California is great and it's been great for 50 years. I think that the other issues being addressed by other non-attorneys here this morning are clearly the key ingredients. And the distinguishing factors among California's COPs or lease revenue bonds are who's obligated to pay the debt and what are their resources to pay it? And so, as you say, we deal with some of the largest governmental units in the state and among the very smallest, and in each instance, it's left to those governmental officials to be certain that their borrowings are done in a prudent fashion.

Brown: You would distinguish between operating cost to be financed by COPs and other nontraditional liabilities such as court judgements? And as a firm, you would feel comfortable in issuing an opinion with respect to such things as court judgement?

Hiscocks: There's certainly express statutory authority for doing court judgement bonds. We had occasion to look at that lately. I don't think we're involved in any particular transaction, but yes, it was likely that that would be authorized. Similarly, as I mentioned, there's certain types of lease financings that I would regard as unconventional, but still appropriate--one would be handicapped access facilities. The State, through the State Public Works Board is now in the process of retrofitting a number of community college districts to provide those sorts of public improvements that show an obvious public benefit and public purpose. In and of themselves, these aren't particularly valuable assets for purposes of securing a lease and probably make a good case for an asset transfer type of structure.

Brown: Thank you.

Hiscocks: Thanks.

Brown: Next, Stan Wolcott, President of California Association of Bond Lawyers.

Wolcott: Good morning members of the Commission and members of the audience. My name is Stan Wolcott, I'm the President of the California Association of Bond Lawyers, also known as CABL which is comprised of many of the bond counsel community and underwriting counsel community in California.

In the interest of saving time and adhering to your five-minute time limit, I'm going to dispense with reading into the record the remarks that I just gave you, but before going to the questions that you asked me to answer during my remarks, I would like to go to the concluding paragraph and at least read that into the record.

For all the foregoing reasons, the membership of the California Association of Bond Lawyers would respectfully submit to the Commission that caution be used in approaching any proposed legislation affecting the issuance of COPs. Until such time, if any, as the constitutional debt limit is modified to require a simple majority vote, lease purchase financing will remain the mainstay of financing much needed public facilities by California cities, counties, and school districts. It would be extremely unwise, particularly given the current depressed state of the California economy, to do anything which would have the result of making this financing structure more difficult to utilize. The trust, which has been reposed in public finance officials has, we believe, not been misplaced, and given the self-regulating nature of the marketplace, will be exercised with prudence and responsibility that we all expect.

Now, turning next to the questions, some of which, I think, have already been addressed by the preceding speaker--and I apologize for getting here late, I had to scramble to find a parking spot. The first of the questions was: Do investors need to be concerned about the legality of covenants to budget and appropriate which are an integral element of California COPs? And I believe Mr. Hiscocks touched on that a little bit, but again, let me read into the record what CABL has produced on that question.

The covenant to budget and appropriate rental and installment sale payments are indeed integral to the acceptance of certificates of participation in the California marketplace. Unlike many other states, where it is not possible to make such a covenant, certificate of participation financings typically include covenants regarding the nonsubstitution of competing assets and provisions regarding nonappropriation. With the exception of the Lassen and the Richmond issues, COPs investors in California have been able to rely on the mandatable duty of the borrowing entity to budget and appropriate for the rental or installment sale payments, subject only, in certain instances, to bankruptcy, statutorily mandated expenditures, and of course, use and occupancy, as Mr. Hiscocks mentioned.

If this were not the case, California would stand on the same footing as the other states just mentioned; and if I were to guess, there would be a resulting increase in the interest rates on California COPs to take into account the more tentative nature of the underlying obligation. To date, however, no final decision has jeopardized the validity of such covenants.

The second question which you posed was as follows: Do asset transfers structures, where lease payments are made on an existing property to finance the acquisition and/or construction of other property, pose any additional legal concerns? And, again, at the risk of repetition, I'll read our response.

The use of asset transfers or equity strips, as they are also known, is a valuable alternative in certain instances in order to properly structure a financing. Such financing structures are typically used where it is desired to avoid the so-called construction risk, which is an anathema to rating agencies and bond insurers, to avoid a payment of capitalized interest during construction and thereby decrease the size of the COPs issue. And in certain instances, where the facility financed is not conducive to a lease, it may provide the only COPs financing structure available.

Absent particular statutory limitations, deed restrictions, and the like, such financing structures are legal and valid, but may pose the occurrence of impropriety in the eyes of the public, analogous to mortgaging city hall. While it is true enough that the facility from which the equity is stripped is subject to all the usual remedies for default, there is no risk of permanent forfeiture or loss of the facility beyond the term of the indebtedness. And typically, issuers will select an asset which is of a less essential governmental nature such as park lands. Properly structured, an asset transfer structure for a certificate of participation issue should pose, actually, less problems than a conventional financing which directly relates to the facility financed.

The third question which you asked us to address is as follows: Do you believe that a transaction, such as the 1989 Richmond Unified School District COP where proceeds were used for operating expenses, is still possible? And, I think, there are two senses in which we could take that question and I'll address both of them.

First, long-term borrowing for current operating expenses has always been bad public policy as was witnessed by the City of New York's debacle in the 1970s. Such borrowings have continued, to date, under various guises such as the pyramid bonds--although I should note, however, that, like Mr. Hiscocks, I'm not aware of any such financings, other than Richmond, being done in California. Certainly, our firm has done none. Although, still theoretically possible, such working capital borrowings, as bond counsel termed them, are going to be much more difficult to do given the recent promulgation of the final allocation and accounting rules and the reimbursement regulations by the IRS. Generally, the IRS has created a disincentive for such financings, other than financings such as tax and revenue anticipation notes, by treating the proceeds of the issue as unspent, thereby making them subject to continuing arbitrage accounting and rebate.

On a practical level, the very fact that the Richmond Unified School District COPs have gone into default, makes it much less likely that any future working capital financing would be accepted in the municipal marketplace in California.

The fourth and final question was as follows: Does CABL believe that current disclosure surrounding COP issues is sufficient, and if not, what particular areas should be improved?

Although time constraints did not allow me to pool all the board members, much less our entire membership, I believe most would respond that the current disclosure for COPs issues is more than adequate. I think this is best illustrated by the fact that, given the default of the Richmond COPs, most bond and underwriter counsel are now requiring disclosure regarding the pending litigation in the bondholder risk section of the preliminary official statement and final official statement. This disclosure is being made, not withstanding the strong belief by most bond counsel, that the current state of the law will likely be unaffected by the case. Similar affirmative defenses were raised in the Lassen Community College District COPs default a number of years ago and were ultimately either dropped or disallowed by the court.

Obviously, a decision in the Richmond case, which changes the present state of the law, would require not only different disclosure, but also a different approach in the covenants as well, as noted in response to the first question. Thank you very much, on behalf of CABL, for the opportunity to speak. If you have any other questions, I'd be happy to address them.

Brown: Any questions? Mr. Woods?

Woods: Yes. I'm not clear on what you just last said, in terms of how disclosure has changed because of the Richmond...

Wolcott: Obviously, an adverse result in the Richmond case, based on any of the affirmative defenses that have been put forward...

Woods: I understand that. You said something that the disclosure has changed and the official statements, and what was that again?

Wolcott: At lease one fellow bond counsel has told me that he was requested--actually he was in the capacity of underwriter's counsel--and it was requested by the bond counsel, to put in a section dealing with the pending situation in Richmond.

Woods: To actually disclose the pending...

Wolcott: Exactly, and we see that in similar context. Obviously, the present case that's before the United States Supreme Court on Proposition 13 is likewise being disclosed because of its potential impact.

Woods: Thank you.

Brown: They don't have to disclose that any more. It was upheld today.

Wolcott: I had not heard that. I have not seen the newspaper this morning. That's good news.

Brown: What can I say? I'll let Mr. Gardner respond for me.

Wolcott: It wasn't good news? Sounds like I'm not in on the joke.

Brown: Well, no, it's reality, that's what it is and we're all going to deal with it. Mr. Woods.

Woods: Let me ask one more, since we do have the Association of Bond Lawyers before us here. Is there, Mr. Wolcott, is there any tweaking, maybe, that you do in terms of disclosure? We have our AB 1200 statute which was recently enacted. I just wondered, in terms of--and they do this kind of thing in Sacramento all the time--we'll just improve disclosure. Could you give us some hints as to what you might recommend?

Wolcott: Well, you've got to realize, Mr. Woods, that just recently, of course, the whole subject of disclosure was the subject of GFOA guidelines and so, that very recent tweaking has already occurred. Now, with direct response to COPs, obviously, every underwriter's counsel and bond counsel who reviews an official statement, given the current situation, is probably going to make darn sure that every conceivable aspect is disclosed, even those that in years past we may not have even thought worthy of mention.

Woods: Very good. Thank you.

Wolcott: Thank you very much.

Brown: Thank you. Next, Stuart Greenfeld from the State Department of Education.

Greenfeld: Mrs. Brown and members of the Commission, thank you very much for the opportunity to comment on issues related to the use of debt instruments including COPs by local school districts. In requesting this testimony, you asked the Department to respond to four questions. What follows is a brief response to each of these questions.

Does the State Department of Education believe that the current oversight called for in AB 1200 is sufficient to prevent school districts from overcommitting their operating expenses to lease payments?. While we don't believe that it's totally sufficient to eliminate the total possibility of any school district incurring lease obligations that it can't afford to pay, we do believe that the legislation should reduce the incidence of the inappropriate issuance of COPs.

In accordance with AB 1200, districts with a *negative* or *qualified* interim report certification in the current or prior year, must have any debt issued approved by the county superintendent of schools. The county superintendent must find that the repayment of the debt is probable before a district can issue the debt instrument. There is no provision for the county superintendent to evaluate the use of the funds, only the likelihood of repayment. However, the Department of Education will be developing guidelines covering issues related to the probability of repayment and the appropriate uses of debt issuance. All districts and county offices of education will see the Department's guidelines.

AB 1200 was built on the assumption that local school districts should control their own destiny until they demonstrate fiscal problems. The county superintendent only intervenes in financially troubled districts. Hence, a financially healthy school district has no obligation to get the county superintendent's approval prior to issuing debt, including COPs, although the counties do review the amount of debt and its associated liability as part of the approval process for school district budgets.

Second question asked of the Department by the Commission is: What criteria is the Department suggesting that county superintendents use to evaluate whether repayment of lease debt is likely for school districts which have a negative or qualified certification?

Yesterday, the Department released an advisory recommending criteria related to short-term debt such as tax and revenue anticipation notes. Due to some unresolved legal issues, the Department's advisory, related to long-term debt including COPs, will be released at a later date. However, in general, this is the approach we are going to take:

1. A district seeking approval to incur debt will complete a multi-year projection covering the period of indebtedness.

2. The district and county superintendent will apply elements of existing criteria and standards for budgets to the numbers generated by those projections. The key elements are the fund balance trends and the reserve requirements of each of the projections. For short-term debt, we will include criteria related to the district's cash flow for the period covered by the debt. Our advisory will include advice on appropriate uses of debt. This is advice only and will be not be binding on school districts or county offices of education.

Third question asked by the Commission is: Do you believe there is a need for school districts to increase their revenue and expenditure forecasting capabilities to better determine their long-term fiscal health?

Our answer is affirmative. Yes, the Department is currently developing a booklet to assist districts to focus on key factors in projecting future revenues and expenditures. We are also promoting the development of appropriate software for use by school districts.

Several years ago, we began to provide training on how to do multi-year projections and long-range financial planning and, in fact, we developed a guide on long-range financial planning. However, due to budget reductions, we have had to eliminate this training on a statewide basis. We are, however, sending a copy of this fiscal policy team guide on long-range financial planning to every school district in the state within the coming month.

Lastly, the Commission asked: Do you believe it would be helpful for CDAC to develop model guidelines for COP issuance by local agencies, including school districts, which could be adopted on a voluntary basis?

Again, our answer is affirmative. Yes, we believe it would be beneficial. The Department has been working with the California Association of County School Superintendents' Business Administrative Policy Committee on many areas related to the implementation of AB 1200. Together, we have identified many of the variables districts should consider before incurring debt.

Many people market financing mechanisms to districts. Not all are in the long-term best interests of the districts. Good advice from the Commission would be very welcome by districts and county offices alike and we would be glad to work with CDAC in this area.

If you have any further questions on these subjects, I'll be happy to answer them to the best of my ability. I've offered and provided the Commission with copies for the Commission members of this testimony, as well as copies of the advisory we're just sending out this week. There are some additional or extra copies should members of the audience want to see that material. I'll be happy to answer any other questions.

Brown: Thank you. Questions from Commission members? Treasurer Merz, do you have any questions?

Merz: I'm going to only mention or comment as a county treasurer. Often I see--in helping prepare or funnel through the resolutions that go to boards of supervisors from schools--but from what I can see, they accomplish little or there is really no room even to not approve them. And I'm just wondering about your feelings in that area, if possibly they should either be eliminated on one hand, or possibly strengthened on the other. So, if there is a distinct problem that you mentioned in one of your questions here, at least the county boards or others would be at least required to make given statements and advice in the key categories, 'cause, as of right now, they just are almost an automatic passage.

Greenfeld: Good question. AB 1200, as I pointed out in the Department's testimony, is really designed and geared for districts that have already experienced financial difficulty. In which case, the county superintendent, in fact, has to evaluate any issuance and determine approval or disapproval.

Your question, I feel, relates to those districts who aren't in trouble, but might be headed in that direction for lack of full disclosure on the indebtedness that is being proposed. The Department's position has been consistent and forceful in advocating full disclosure, not only on the debt instruments, but several other areas, which, heretofore, we have felt have not been adequately disclosed. And as you know, another section of AB 1200 addresses pending bargaining unit agreements in which full disclosure is required. I would think that the full disclosure for those districts, who are not in financial trouble, would be of benefit and value to the public and would assist in ensuring increasing the insurance of solvency within that district.

Brown: Mr. Woods?

Woods: No questions.

Brown: Let me ask a few questions about the interim reports. By now, most of the school districts are supposed to have the filed reports. Have they all?

Greenfeld: Yes. I think we have two districts that remain outstanding out of the thousand plus school districts in the state.

Brown: And, have you, if you have had the opportunity to review those, how do the finances look?

Greenfeld: Surprisingly, not as dastardly as one might expect or predict. This is the second interim report during this fiscal year. We have, currently, two districts that have filed negative interims -- Coachella and Antelope Valley. They are the same districts that filed on the first interim negative certifications. We have 21 school districts who have either certified themselves as qualified or certified themselves as positive and were challenged by county offices as being qualified. So essentially...pardon?

Brown: Twenty-one challenges?

Greenfeld: No. I'm saying they either certified themselves as being qualified or their positive and their certifications were challenged by the county offices. I think it breaks down to about 16 or 17 districts that certified themselves as qualified and three or four districts who certified themselves as positive, that the counties then challenged and converted to qualified certifications. That is not substantially different in numbers than what we had on the first interim. That's surprising, from the standpoint that--having worked with the schools for the length of time I have--that there has been, what someone called, more elasticity in the system than would be expected because of the difficulties in funding over the last few years and the prospects of additional difficulties in State funding for the coming year.

My own view of why this has occurred, is that, I believe, given the economic conditions of the last few years, school boards have been willing to bite the bullet more and make those hard decisions and those hard budget reductions to accommodate restrictions in revenues and they have been doing, in general, a very good job of having less and having to reduce expenditures to reflect a lesser amount of revenue. The issue and the question becomes; How much further down a line can they continue to cut before serious questions are raised as to the quality of education that we're able to provide in this state to our children? So that's where we're at, at the moment.

Brown: Yes, David.

Woods: I do have a question, Madame Treasurer. In your testimony, you indicated that you had to reduce the training of school districts because of budget problems. It just raises a concern that I see in many areas in the oversight/audit area that it's so easy for the budgeteers to cut away or to extend audit cycles. My question is, are you equipped to stay at the ready on this, in terms of the review of AB 1200 applications?

Greenfeld: I'm not quite sure about your question...

Woods: Well, do you have enough people to review these applications and get back to the school districts in a timely manner? Auditors, reviewers?

Greenfeld: That's sort of a multi-faceted response that I have to give to you. The Department is charged with a variety of responsibilities. One, of course, is to monitor the interim fiscal reports and to raise questions with local districts and county offices where we have serious concerns about certifications and so forth. We are, currently, equipped in our resources to be able to do that and are doing that.

We're also charged with the responsibility of reviewing and approving all the county board of education budgets, just as the counties review and approve the district budgets and, again, we do have resources to accomplish that process as well as several other responsibilities we have.

Where we're very deficient, at the moment, because of the budget reductions suffered over the last several years in the Department, is in the area of being able to provide training and new publications and to support what we had already established as a base during the last five to six years in direct service to districts and county offices. For example, we have published a series of six guides on fiscal policy team training that deal with such subjects as the long-range financial planning, budget development, auditing and accounting, school facilities, nutrition, maintenance operations, and so forth. These guides were used as part of training sessions provided school board members, superintendents, and chief business officials throughout the state. That training program has been eliminated during the past two years as well as the continuation of publications on various topics related to this series. So, in that view, we are not, we do not have the resources to continue.

Woods: In this procedure, where you review these applications, I'm talking about the people that review these negative certifications you mentioned about being challenged and...

Greenfeld: Oh, you're talking about the interim certifications.

Woods: In that instance, is there a provision where the application becomes effective without review where the burden is on you?

Greenfeld: What was confusing to me was the term application. These are not; we don't term these things applications. Generally, we call them certifications.

Woods: But, are you able to get back to them in a timely manner? That's my question.

Greenfeld: Yes, I want to make it clear that the Department does not have the responsibility of reviewing the thousand plus school district certifications. The first line of defense there is the county offices of education. so with a local school district certification, it would be the county that either agrees with the district or challenges the district's self-certification. They would notify us if they challenge them and then we would review those challenges. The county offices of education certification are those we have direct responsibility for reviewing and we do have the resources to follow up on that review.

Woods: Are the counties able to get back to the local school districts?

Greenfield: Yes, and they do in a very adequate way, I believe.

Woods: Thank you.

Brown: Let me just ask a couple of questions about COPs in general. Does your department routinely approve or certify the issuance of COPs by school districts throughout the state?

Greenfeld: No, we do not.

Brown: Have you voiced any approval for the use of COPs? Have you disapproved? Have you, by policy guidelines, said that COPs are inappropriate?

Greenfeld: As I'm sure you're aware, we have no legal base for approving or disapproving the use of COPs at this time. What we did, however, in a very strongly worded advisory was to issue a recommendation not to use COPs for general fund deficits or operating expenses. We issued that statewide to all the districts and county offices in the state in a strongly worded set of advisories.

Brown: When was that?

Greenfeld: This was over a year and a half to two years ago and we've consistently supported that position since that time.

Brown: But that advisory would then presume to support the issuance of good COPs that were not being used for operating expenditures.

Greenfeld: Yes, I think the Department's belief is there is such a thing as good COPs.

Brown: And, therefore, legal COPs?

Greenfeld: And legal COPs, yeah.

Brown: That would not be in violation of the...

Greenfeld: That's correct. We would...

Brown: It would be very helpful to have the Department say that in a booklet.

Greenfeld: We have, and, I think we have said or we may not have said it as loudly as some would like, but we do have several examples of good use of COPs.

Brown: Actually, you've said the contrary in a list of responses in a courtroom. I'm told that you're not with the legal department.

Greenfeld: That's correct and I'm not prepared to...

Brown: I do think it is an important issue that should be joined that there has been for years an acknowledgement and acquiescence of support for the use of lease-backed financing by school districts throughout the state and the Department of Education has not issued any advisory to say don't do it, if they are for other than operating expenditures.

Greenfeld: Yeah, that's correct.

Brown: Thank you. Thank you very much Mr. Greenfeld.

Greenfeld: You're very welcome.

Brown: The next speaker is, excuse me, Mr. Greenfeld. Thank you Stuart. Thomas Duffy, Superintendent of Moorpark Unified School District and the Past Chair of the Coalition for Adequate School Housing commonly known as CASH.

Duffy: Thank you. Good morning.

Brown: Good morning.

Duffy: I am Tom Duffy and I'm representing CASH and I'm also a superintendent in California at the Moorpark Unified School District. Let me note in advance of my comments that Ms. Brown, you'd asked me to address four questions:

> 1) How is the issuance of COPs helping school districts meet their capital outlay needs?
>
> 2) Does CASH believe there are instances where the use of long-term lease proceeds for operating expenses of school districts can be justified?
>
> 3) What would be the consequences to school districts in California if their ability to use COPs for capital improvements and portable schools or equipment was curtailed?
>
> 4) In your opinion, would the authority to approve local general obligation bonds by majority vote reduce the reliance upon COPs?

Hopefully I don't sound very pugilistic this morning. I may sound challenging in some of my comments, but recognizing your spirit and sense of humor, you may agree with me and may appreciate some of my comments.

A commonly held belief of control agents in state government, is that those that deal with K-12 education--those school administrators who deal with K-12 education and finance--are not competent in the areas of business and finance. The Coalition for Adequate School Housing, the only organization in the state dealing exclusively with issues of school facilities, legislation and capital financing, respectfully takes issue with this belief. CASH is hopeful that the California Debt Advisory Commission has no such notion and will not contribute unintentionally to that bias.

Certificates of participation have been a valuable finance tool for school districts, county superintendents' offices, and other public entities since the passage of Proposition 13 in June of 1978. Certificates provide an opportunity for school districts to finance capital projects, matching payment schedules to income from identified sources, such as developer fees, leases and rents from surplus properties, tax increment allocations, and, of course, the precious district general fund. It is clear that without this important financing vehicle, many capital projects which are currently housing pupils in K-12 programs would not exist.

Getting to question number one, the issuance of COPs by school districts and county offices are permitting these entities to provide for student housing needs in several ways. These financial transactions have assisted in the acquisition of land and/or in the construction of permanent school buildings, and in some cases, regional occupational complexes--something that I haven't heard noted recently in discussions of these vehicles.

Portable classrooms have been acquired in many instances and COPs have been a popular means in acquiring the portables in that State policy has allowed that during the lease period, they are not chargeable under the State's School Building Aid Program. So that has contributed to their popularity. The use of COPs within the State Interim Financing Program, I think is, is good and has been done effectively. However, because of the State's two-year limit on the repayment of interest, I've seen that some districts have attempted to do financings in other ways because COPs can be costly in the short term. My district did enter into this Interim Financing Program and chose not to use a COP, although we had COPs for other reasons. Because of that, it actually saved the State some money and utilized a simple note because of the two-year period.

On the question regarding the use of COPs for operating expenses, CASH recognizes that in rare instances of special needs and unique circumstances, uses of long-term lease proceeds for operating expenses of school districts and other public entities may be justified. It is important to note that the purpose for the issuance must be identified in advance and communicated to all participants and noteholders. An example of this is the funding of self-insured liability program within the Ventura County self-funding authority, that's my own county, a joint powers agency (JPA), that issued COPs in 1987. This was, to my knowledge, the first COP used to provide a liability insurance pool and has contributed to the savings of a tremendous amount of money. Or, if we were to buy a liability insurance program for the coming year, we would probably spend about $1.1 million for all the school districts that are within this JPA. I'm sorry, we'd spend about $2.2 million. What we have set aside is $1.1, and that money, of course, is there and may be used in the event that we incur liability. If we do not incur liability to any large degree, then that money is there to use again. So in essence, we are saving our own money. This was a prudent way to use these funds.

It's important to note that I'm not talking about using funds from a COP to pay salaries or to pay utility costs or other operational expenses, but in rare instances such as this, I think, it's a justifiable use.

CASH supports the concept of the simple majority vote and has tried to move that legislation. CASH believes that the negative experience of districts seeking approval of general obligation bonds through the very restrictive two-thirds vote has lead many to COP issuances, in that these can be controlled and planned to accommodate the demand for pupil housing. It is logical that the reliance upon the issuance of certificates would diminish with the advent of simple majority vote. We've gone to that, obviously, because it's something that we can access, and with school districts, such as my own, that have grown as much as 24 or 25 percent in one year without adequate funds, we need to rely on things such as COPs and have done so.

CASH will aggressively oppose any attempt directed at curtailing the ability of school districts or county offices to enter into COP financing transactions identified to create capital projects. There are two reasons for this opposition. First, the COP financing tool has proven to be a viable mechanism for education entities to meet growth needs within a dynamic society, under an era of tremendous fiscal conservatism on the part of the Legislature and the electorate. Second, there is no reason, other than bias toward school agencies, and particularly school districts, on the part of state-level bureaucrats and legislative representatives, for such a curtailment.

It is unfortunate that the circumstances surrounding the fiscal difficulties of the Richmond School District has weakened the reputation that school districts have in California regarding the prudent and responsible management of their fiscal resources. The irony is that school districts, for the most part, are actually highly experienced in dealing with fiscal matters and that it is the constraints of the dependents upon State income, and the further constraints provided through State statute, including collective bargaining obligations and workers compensation administration programs, which work in vise-like fashion to disable well-managed school districts. Districts are, at times, left with nothing really to manage.

If the unspoken question of the Commission is: Shall the position of the Commission be identified of one which is suspicious of school districts abilities to prudently incur and repay debt created through the issuance of COPs? The recommendation of CASH is that the Commission become schooled in the reality of the circumstances and characteristics of school districts in California. Districts, for the most part, do a very respectable job of managing their fiscal resources inspite of the perennial uncertainties of the State-financed education system.

If this testimony appears to take issue with a slightly veiled hostility toward the capability of school superintendents and fiscal officers by state officials, it is intentional. It is the position of CASH that the Commission must recognize the highly successful practices of most school districts in California. Districts are dealing with tremendous levels of growth in the K-12 population while managing with diminished general fund resources amounting to what is estimated, at this point in time, as a 10 percent deficit within the two year period of 1991-92 and 1992-93. These agencies must also compete within a very restrictive program of capital outlay distribution, operated by the State, which is the main resource available to permanently house pupils.

The position that CASH has taken since its formation in 1978 in the wake of Proposition 13, is that the State of California is responsible for the provision of safe and adequate facilities. The Coalition recognizes that the State has not had the ability to meet those responsibilities fully and that school districts have been imaginative and industrious in finding various means of providing capital dollars for the acquisition of land and the construction and modernization of school facilities.

It is the recommendation of CASH, that the Commission note the high level of professional service provided to children of California by school districts, who have used COPs to construct facilities and that the State has been unable to finance for them.

In conclusion, CASH recognizes that it is important that the Commission look at the circumstances that the Richmond School District, as not being a standard for school districts in the state, but as an exception. School district superintendents and fiscal officers are not frustrated educators who find themselves in decision-making roles for which they are not well-equipped. They are, rather, educators and practitioners of other disciplines, who have taken a tremendous challenge in managing agencies which do control their own sources of revenues, but which are held accountable as if they did.

I respectfully stand here to answer your questions at this time.

Brown: Well, you seem a little grumpy today. I mean, and now I'm a control agency. I don't think so. We're just from CDAC and here to help.

Duffy: I have noted your willingness to help. You've attended two CASH conferences and you've been very supportive of a legislative program that we have had outlined, including ACA 6, and we're most appreciative of that.

Brown: I must say, as a former school board member, I feel the frustration that you evidence by your remarks. There are not enough resources to do the job we need, but that, too, is reality so getting about the job of figuring out...

Duffy: That's why we're here.

Brown: ...how to do it is why all of us are here. Are there questions from the Commission members?

Woods: Well, thank you Madame Treasurer. I, too, would like to commend the directness of the testimony. I appreciated it. Thank you. I just have one question on the issuance of COPs for the liability insurance pool.

Duffy: Yes, I thought you may ask about that.

Woods: It just occurred to me, I just wondered. Do you have in that financing, it would appear to me that that's a, it could be anyway, a continuing type of financing for COPs and I just wondered on that particular transaction, is there some agreement to keep issuing COPs?

Duffy: No. It was a 10-year COP transaction. We're about half way through it. It has been highly successful. We're delighted that we were able to do it and we have saved a tremendous amount of money. When we issued the COP, other public agencies were shutting down services. I don't know if you recall what was happening in 1986/87. We, of course, couldn't shut down education operations. We had to have a liability insurance program and we found this to be a tremendous tool. It was not an easy one to bring about because there were those who did not necessarily believe we could do it, but I'm really glad that we were able to because, in essence, we freed up money in our general funds to place into classrooms and focusing on the education programs.

Woods: Do I take it that that fund is actuarily reviewed every year so you're OK in terms of reserves?

Duffy: Yes, it is.

Brown: Thank you.

Duffy: It is actuarily reviewed yearly and the interest earnings are reinvested, as you might well imagine, and we watch that very carefully.

Woods: Very good. Thank you.

Brown: Treasurer Merz?

Merz: No, I don't have any questions.

Brown: Let me ask a question. Have you and your organization given any thought to what the implications will be, if the school voucher initiative passes, on school facility financing?

Duffy: There have been informal discussions and speculation. The belief is that there will be a tremendous amount of work for freelance consultants to do quite a business. I think that, my personal view is that there will be a great deal of difficulty for certain districts, particularly districts that are in urban areas because of the loss of general fund revenues so you wouldn't have that as a backup. So I worry about that.

Brown: And you do not support the use of COP financing for operating expenses?

Duffy: Not in the sense of salaries and other uses, no, but in instances, I see liability insurance as being...

Brown: Nontraditional uses such as the liability insurance. Other areas that you have contemplated or seen?

Duffy: No. The one other area that I guess--it wasn't really a contemplation, but a thought that I didn't hang onto very long--was the use of COPs along with the acquisition of other kinds of equipment for something that really wouldn't be considered such as a software lease in an elementary school, or elementary schools. These are expensive, and if you have a number of elementary schools, it can be quite expensive. I have not done that, but it's something that, with time limitation on it, recognizing that, in the future, we may want to change the use of a particular software lease. Are you familiar with what I am talking about? That a company that provides a software program that is updated annually, and sometimes even more so, to keep up, to be consistent with the curriculum...

Brown: To keep it current.

Duffy: Yes. And so, and that's something, by the way, that we also review. I've not used a COP for that, but I've thought about that.

Brown: Have you done, or have school districts pooled together at all to do COP issuances for equipment leases, similar to what we heard about. I forget who it was who talked about the master lease program. Is there any inter-district cooperation or would there be a benefit to, say, a State pool for a master leasing program for districts, or is there not any similarity in equipment?

Duffy: Well, I know that it does exist. I think it was through the Sam Farr legislation of about five or six years ago that began this, so that it certainly does exist, but you're, I think you're question is, would that be a valuable tool? And I think the answer is definitely. If school districts can cooperate in joint powers authorities or other means to have a greater weight to their fiscal integrity, I would say, yes, absolutely.

Brown: Well, we have legislation pending that has not received a positive response from the Legislature, to provide some assistance in State pooled issuances for COPs that would have an intercept security device...

Duffy: I recall that, yes.

Brown: ...and that was not approved in committee, but it was not for equipment per se, but it was for the general COP financing for school facilities.

Duffy: That was the one that, if I remember correctly, was that a Leroy Greene bill?

Brown: Uh huh.

Duffy: That in the event that there was a default that the State would then reduce the apportionment, that would be the general fund apportionment...

Brown: Right, that was the ultimate guarantee.

Duffy: I think that there's value in that. I think, just as in any financing, a school district has to go into it recognizing what the downside, what the worst case could be. And the worst case is going to be there if they do the financing whether the State can reduce its apportionment or whether they have to make the decision on their own. So I recognize that. I, in fact, gave some input for that legislation.

Brown: OK. Well thank you very much, Mr. Duffy.

Duffy: Thank you very much.

Brown: The next speaker is Sandra Lemmons. She is representing Marlene Brownell, from the California Association of School Business Officials.

Lemmons: Thank you. My name is Sandra Lemmons and I'm the Deputy Superintendent for the Modesto City Schools, representing Marlene. She's not able to be here today and with the experience that I've had in issuing four certificates of participation in two districts, she asked me to represent CASBO. And I appreciate Tom's comments because I might have been too person like to make some of them, but I certainly back him up on them.

You asked me to respond to questions about CASBO's position on the issue of COPs for operating expenses. You asked me to respond to how the State Department of Education or other agencies could help us in the issuance of COPs. And you also asked about our position, our feelings about the majority vote, if that would change our position on COPs. And I think my remarks will answer those questions, and if not, probe me further.

First of all, for those who may not be familiar with CASBO, the California Association of School Business Officials is the major professional organization for school business officials here in California, and is an affiliate of a national organization. We've been an organization for over 65 years. We provide professional development and networking opportunities to members and nonmembers alike through local, regional, and statewide conferences attended by thousands of people each year, and through publications that are produced through our research and development committees comprised of experts in various school business fields. Each year, workshop sessions and publications address the appropriate ways to generate and manage capital funds for local school districts, for instance.

In recent years, particularly in light of the reductions in the State Department of Education, the Association has assumed a strong leadership role in providing guidelines, manuals, training, and what have you in the various aspects of school business. As a member of the CASBO's Finance Research and Development Committee, I have personally participated in a number of workshops, presentations, and guideline development in the area of financing for capital needs.

Given the almost impossible charge of meeting mandated education requirements, it is a miracle that more districts are not in financial difficulty. However, issuing COPs to provide operating revenues--which amounts to borrowing money to pay your house payment--is no more defensible than continuing to deficit finance over a period of time, rather than reduce ongoing expenditures to align with available resources, no matter how painful the process or how unfortunate for our students that process might be.

Of the more than 1,000 school districts in the state, as Mr. Greenfeld mentioned, the latest interim financial reports showed only two districts which did not expect to be able to meet their obligations this year, and 21 which filed either were qualified or were challenged on their positive statements. These districts will now be subject to detailed State and county scrutiny as they develop their budgets, and will not be able to issue nonvoter-approved debt without county or state approval.

One of the greatest challenges facing districts today is in the area of capital outlay infrastructure. When the upfront costs are very large, it may not be possible, and may not make the best business sense, to pay cash upfront--something, believe it or not, school business people are capable of, business sense. Most businesses do not pay cash for major capital outlay, but use financing techniques to leverage their funds. The importance in school business of properly managing out assets is no different. Unlike other businesses or service providers, we cannot tell our clients we'll put them on a waiting list. When a child walks through the door, we have to provide classroom space. We must buy buses to get them to school. We must buy computers to provide proper education for the 21st century, as well as to maintain the complex accounting systems required for schools. Cash payments for these large purposes is often not the best business decision.

AB 1200 has been discussed quite a bit this morning. This provides a new system for county oversight. Three times each year, the county must review and approve a district's budget and current financial reports. If there are concerns, the county can step in and override district decisions. The district would have to try very hard to get into unsolvable financial difficulties from now on, in between these three annual reviews. As I recall, when Richmond first decided to issue the certificate of participation, there were a number of us, particularly the Finance Committee, who were dismayed about this because we felt that even though it was one out of many, many issues, that it would raise some concern and cause scrutiny for certificates--and certainly it has. I think AB 1200, now in its place, would provide, and perhaps keep this from happening.

Certificates of participation are one of the only options available to school districts for some projects. Grant anticipation notes are suggested while awaiting State funds but are not a feasible alternative, because of the uncertainty over when the State will actually be able to release the appropriated funds. The district may be assured of receiving the funds and, therefore, able to buyout a COP issue, but no specific date can be set in which a note could be definitely repaid.

The four COP issues for capital projects that I have been involved with, have had a specific nonoperating fund revenue stream for security. These have been developer fees that are already on deposit, property sales, lease revenues, interest earnings on those property sales, redevelopment funds, and also enterprise funds, such as the nutrition service center we built in our school district recently and will be repaid through the increased revenues from the food service program.

While the general fund may be pledged as backup security, this is done to, in our estimation, enhance the rating of the issue and lower the cost to the district. Having discussed this issue with other CBOs, I can attest to the fact that the security of the general fund is of paramount importance to any school business official and would not be jeopardized by any competent professional. We can't legislate against blatant mismanagement, but I believe we can now rely on AB 1200 to allow county offices to prevent ongoing problems. I would like to point out that this oversight is provided only for school agencies; other local agencies have no other entity monitoring the fiscal activities to this extent.

School officials are not incompetent country bumpkins unable to make responsible fiscal decisions. Most districts of a size to be issuing certificates have well-educated, properly trained business professionals managing their fiscal affairs. I think that's evidenced by the kind of pressure that we're under year after year. And after the year we've just completed, we face another one. I'm adopting what I'd like to call a sham budget on Monday night, because I don't know how much more I'm going to have to cut. I've already cut $6 million in two years--very difficult. But to have only two districts issue a negative out of over a thousand, after the year we've had, I think is remarkable and it says a lot for us. Thank you.

The days when even the largest school systems had educators without business training acting as chief business officials have long disappeared. Our professional organizations such as CASBO and the county offices provide ongoing training opportunities and advice. Even the smallest districts in the state have these resources available and rely heavily on the county offices to manage their financial affairs. Pools, such as the one operated by the California School Boards Association, also provide access to COPs as a funding mechanism for smaller districts without expecting them to be financial experts. The pool screens the viability of the issues to prevent fiscal jeopardy.

Schools are big business and the school business professional utilizes many of the same tools as other businesses do in managing their assets and fiscal affairs. All businesses and public agencies are facing difficult financial times right now. The situation is no different for the State or cities and counties which rely on tax revenues which fluctuate with the economy or for school districts which rely on a combination of those local, State, and federal funds.

However, the experience of Richmond Unified, one of over one thousand districts in this state, should not outweigh the positive benefits that COPs provide districts to manage the capital needs for housing and other facility requirements without the time and additional costs associated with general obligation bond elections which, at the current two-third vote, are nearly impossible to pass. COPs provide a method by which districts can fulfill their capital needs from existing revenue sources without additional tax burdens on their communities. I'd be happy to answer any questions.

Brown: Thank you very much. I don't think we think that any school business official is a country bumpkin. We co-sponsor with CASBO, many of the financing seminars and appreciate the opportunity to work with local government agencies at the school side, and the city and county side, to insure that they have the best information possible. And we appreciate the comments that you've made today.

Let's see if my colleagues have any questions. Treasurer Merz?

Merz: Maybe just one comment along the line that you were just speaking. I found, as a county treasurer for some years, a very good relationship with the county office of education in the very large districts. I found that often, they sometimes advise, or I sit in on certain things by their invitation, I find less of that from, sometimes, the smaller districts, not that they may not be qualified; but I'm wondering if you see that, whether the smaller districts have the opportunity to attend some of the seminars, get the education. I feel sometimes, that they need it the most and are the least ones that come asking for help and advice.

Lemmons: I think probably your comment is well taken. I think they are so busy managing and they're spread so thin, that they do rely upon the county offices to usually spread the word for them. The county offices do a pretty good job of taking care of their smaller districts and they have a lot of in-service and what have you. But the small districts also have very little flexibility. They don't have the dollars that a larger district may have to invest or to do these things.

Merz: We see them less.

Lemmons: And generally, your small districts are leaving their money in the county pool. They're not moving it around or doing anything with it, or, if they have at least a minimum amount, they're putting it in the Local Agency Investment Fund if they even know about it, which is doing well.

Brown: There are some that don't know about LAIF?

Lemmons: Oh, there are many districts. I participate in a training program for people who are moving into the school business field and one of the first things I tell them about is the Local Agency Investment Fund, and it's surprising how many people, who are even current business people, have not heard about it. So I spread the word.

Brown: Well, we'll have Pat Beal call you. Great, make a note, Pat Beal.

Let me ask you a question about school district operations, generally, from a business official's perspective. Do you think that we could achieve greater efficiency and cost savings through the consolidation of some of the districts that are out there, given the size of them?

Lemmons: Yes, I do. Definitely. We all, we're called "Mother Modesto" because we have two geographical areas. We're actually two separate school districts and we have a joint administration and a common school board, but the geographical area of the elementary district is much smaller than the geographical area of the high school district. I believe there are five feeder districts beneath the high school district, besides ourselves, or maybe six.

Brown: And they each have a superintendent?

Lemmons: And they each have their own superintendents, school boards. They have to do their own budgets and what have you.

Brown: Now, isn't this a place that we should be looking for redesigning government?

Lemmons: The structure of it is very difficult, but then you have, certainly, the local politics to deal with. San Mateo, when I worked there, I think had three or four unification elections with the San Mateo Union High School District with seven cities and we could never accomplish it. The issue, obviously, was local control--not wanting to give that up. But from a dollar point of view, I'm sure we're spending more money.

Brown: Well, we may find that the dollars will dictate some normally unpalatable changes...

Lemmons: Yes, it's already dictating some very unpleasant changes.

Brown: It would be interesting to challenge the school establishment to come up with a plan that would be acceptable, from an institution point of view, but does respond to the limited resources that we have available, and also you bring the expertise issue up in terms of sophistication of financial management for some of the very small districts.

Lemmons: We do a lot of things like joint powers for transportation, our nutrition services center. We're going to be doing the county jails, we're doing a number of the school districts already--getting the meals out to them; insurance pools--all these things that we are doing, pulling ourselves together because we know we have savings that way. We can do it other ways as well.

Brown: Thank you very much.

Lemmons: You're very welcome.

Brown: The next speaker, from Leifer Capital, will be Barbara Lloyd.

Lloyd: Good morning, Ms. Brown and CDAC members. My name is Barbara Lloyd. I'm an Assistant Vice-President at Leifer Capital and Jeff Leifer, the president of our firm and your originally invited guest, expresses his regret at not being able to be here. He is very disappointed. He has been called out of state unexpectedly on some personal business and asked me to present, on his behalf. We definitely appreciate the invitation and apologize that we couldn't let you know a little bit sooner.

As financial advisors, we see our role here today as not just representing the experience of our firm, but also sharing the experiences that we've gained working with clients whose participation in COPs ranges from, I think, below $3 million to $100 million refundings and more.

The focus of our testimony is a subject that has long been a focus of our financial advisory practice and a theme with our clients, and that is accountability. For us, that means accountability of the issuers to the voters and to investors, and accountability to the financing team to the issuers as well.

When we were invited to speak on this topic, we actually surveyed some of our clients to obtain their input and perspective. Of course, our comments should be considered the views of the firm alone and not representing the views of those clients, but we did want to let you know, and reassure our clients, that we try not to operate in a vacuum.

The first question that we've been asked to address is: What steps COP issuers can take to ensure that they do not become overcommitted to lease payments as part of their operating budgets?

We do believe that accountability and control of COP issues and other financing mechanisms can be achieved. One of the ways that we believe that this can be accomplished is through the use of debt advisory committees, debt capacity reviews, overlapping debt studies and the like. These are planning and evaluation mechanisms that are truly most useful if implemented on an ongoing basis and not just at the time a particular transaction is being contemplated. And I'm going to talk a little bit about what I mean by these items.

A debt advisory committee is an important step to achieve accountability. It's, formation is designed to improve communication to ensure cost-effectiveness; to generate political support for the ideas of the people on the committee; and to really allow quality multidisciplinary analysis of financing alternatives. We stress the multidisciplinary aspect of debt advisory committees with our clients and we think that that leads to the success of those committees in improving accountability. In the end, we also think that it achieves the goal of increasing confidence, both among other officials and at the public level and the quality of the decisionmaking that's being implemented.

The form of a debt advisory committee can vary based on the needs of the district. Traditionally, we see representatives from the top administrative and management offices, planning, public works, and obviously finance, legal counsel, etc. involved and, very often, the role of an issuer's financial advisor is also very important to provide some outside expertise, staff support, and the like. And our clients keep us very actively involved in the activities of these committees.

We've been very encouraged by the recent growth in the use of these committees, not just by our clients, but by other folks in the issuing community. At first, people may consider them just another layer of bureaucracy, but we found that they actually work and it justifies the extra time and effort in terms of the enhanced communication and enhanced quality of decisionmaking.

Another thing that we advocate is use of a debt capacity review. It's a dynamic financial planning tool. We're increasingly being asked to prepare these on behalf of our clients. These reviews typically evaluate key credit indicators: everything from local economic conditions, financial conditions, debt burden to management administration of the issuer itself. These reviews look at historical performance, they track trends over time, and they examine the potential future impact of an agency's financing plans.

Part of the outcome of this is an opportunity to examine ways in which all these factors will affect the credit image of an issuer in the market, which ultimately affects the very cost-effectiveness of the financings. We look at financial condition and economic condition down to details such as population trends, labor force trends, property tax assessments, collections, etc. We look at operating deficits and surpluses, and even get to the point of looking at financial leverage ratios and the trends with those ratios over time as key indicators of fiscal capacity.

Another thing that our issuer clients are increasingly looking to us to assist them with is exploring overlapping debt. The whole issue of burden on taxpayers and burden on the public, or debt among overlapping jurisdictions is really the next threshold, I think, in this area. And the overlapping debt studies that we're starting to do are, in fact, the logical phase two of any issuer's debt capacity program.

We're basically looking, as I indicated, to identify the burdens on local taxpayers; to identify and address any problems--any overburdened areas--on a proactive basis and to really increase communications among overlapping jurisdictions so that people do have a way of tracking what each other is doing.

And finally, we, we do truly believe that an issuer benefits by using an external advisor in their financing programs, even though that may sound a little self-serving coming from a financial advisory firm. But the presence and active involvement of an advisor really can go a long way toward achieving the accountability and cost-effectiveness of a financing plan and assisting an issuer in gaining additional credibility.

The second question we were asked to address is: What specific criteria should COP issuers consider when determining whether to issue lease debt versus other types of financings such as general obligation bonds?

In our minds, some of the key decision factors, when faced with this choice, is whether or not there is existing fiscal capacity, other constraints, timing requirements, and other local economic and political climate considerations.

Clearly there's some built-in advantages for general obligation bonds. You can have "self authorization" characteristics by authorizing more than you need in the immediate term and issuing over time; they are fairly inexpensive to issue as compared to some alternatives; relatively low coupon rates; and timely issuance once the bonds have been authorized--are all attractive features.

If you don't need additional revenue-generating capacity for the projects in mind, issuers may find that, because of timing constraints or others, lease financing may be a better alternative. I think, we think lease financings are also very appropriate when what you're doing is diverting funds that might have been budgeted for a similar purpose. For instance, lease payments to a private entity for space, and you are taking money on an annual basis that would have been paid to a third party, and using that to offset debt, or lease payments in the case of COPs, on an annual basis, and then gaining at the end of that the public ownership of the facility. We think there are definite benefits there, but for those agencies that are going to require increased revenues, perhaps general obligation bonds may be the best and most practical mechanism because of the ability to increase fundraising capacity.

I think, in any case, we encourage people to look at some sensitivity analysis as well. An issuer that has determined that there is sufficient capacity existing, may need to run some sensitivity analysis. How much can go wrong before we can still continue to make these lease payments without any additional fundraising capabilities? That's something that we do work with our issuers to identify. I guess the last is, again, maybe a reiteration of timing. It depends on how quickly somebody needs to move. Support of the local community is another issue that, of course, issuers are going to have to look at. What kind of financing mechanisms will be supported by the local community?

The third question is: If local agencies were authorized to issue general obligation bonds by a majority vote, do we think that there'd be a shift away from reliance from lease debt? Jeff asked me to say, up front, that we do support authorization of G.O. bonds with the simple majority vote. At the same time, we're not exactly sure what impact it would have yet and would be more than happy to be involved in efforts to survey a little bit more.

Brown: Great! OK.

Lloyd: I think the last question, if we have a couple of more minutes?

Brown: If you could just wrap up.

Lloyd: I will. What additional steps the State can take in its leadership role? We think that the educational programs CDAC is doing great. It's a step in the right direction. We'd like to see continued use of that. We'd also like to see a clearinghouse function enhanced for CDAC to provide more information to local issuers. We'd like to have CDAC consider additional watchdog functions--for instance, oversight of some of the statewide pools that are not actually affiliated with the State, to address some well known concerns in those areas. Finally, there are State actions, whether it be enhancing the certainty of revenues or getting clear direction on policy issues that affect market perceptions of COPs, that could clearly make a difference to issuers. Thank you.

Brown: Thank you very much. I was interested in all the debt management suggestions that you made and that may enter into some of our recommendations for local governments to develop some of those debt management programs. Any questions? Mr. Woods.

Woods: Just one in terms of a policy of your industry. I take it that you, you indicated that you would support the majority vote for local G.O. bonds?

Lloyd: Our firm does.

Woods: Are there any initiatives that you folks are undertaking to do that? Any private initiatives as an industry?

Lloyd: I'm not personally aware of an organized initiative in that regard. Certainly, we'd be happy to consider participating in that.

Woods: The other thing is, I just wondered, in all of this work that you do, do you do any analysis along the way that tells you that you can do a better job if you had the bonds as opposed to COPs and do you then build cases like that, that maybe you could come forward with and present empirical evidence that, yes, you know, we do need more authority to issue bonds?

Lloyd: Certainly, we have had clients who did not have capacity to issue a COP and whose discretionary revenues were too low despite the urgent need for some projects and because they had access to short-term funds only, were prevented from doing the kind of COP issue that they might have liked to do. And our recommendations, in the case of those feasibility studies, was that they either find some discretionary revenue, in terms of readjusting some of their other budget priorities, or find a way to issue the G.O. bond.

Woods: Yes, yes I understand. I'm talking about building, like files and arguments or things to sort of give you a foundation, maybe, to present convincing arguments for majority vote provision bonds. Anything like that at all in your firm or your interest group?

Lloyd: Well, we have not made it a specific charge, that I'm aware of, to do that, but I think that we would be able to contribute to an effort like that.

Woods: OK. Thank you.

Lloyd: Sure.

Brown: You represent a number of the smaller counties, don't you? And smaller communities around the state to school districts?

Lloyd: We represent a variety of counties, both large and small, but there are a number of smaller counties and school districts, in fact. Folks who are traditionally issuing under $5 million in debt each year, for instance.

Brown: OK. Great. Treasurer Merz, do you have any questions?

Merz: Just one question. You commented somewhat on overlapping debt. That's something I've been more interested in the last few months. Do you see any way, I can see it would be much more helpful to have more transfer of information between the various areas of government about debt, maybe prior to the knowledge that we have now through CDAC and other publications, that could help us, might even change our decisions, might decide when we go to market, might be different--do you see any way that that would be helpful from what you've seen.?

Lloyd: Yes, we definitely do and I think one of the reasons that the goals of the overlapping debt studies that we are beginning to undertake with our clients is to, in fact, increase communication at the local level. We've talked about the clearinghouse function and the ability to track overlapping debt through CDAC, if the capabilities were enhanced, but you make a good point. That's usually after the fact or at least somebody's financial plans before CDAC receives the information about an intended issue so we think that the overlapping debt studies can be a step toward better communication.

Brown: Very good. Thank you.

Lloyd: OK. Thank you very much. Appreciate the opportunity.

Brown: The next speaker is Kent Taylor, County Administrator, Santa Barbara County and following Mr. Taylor will be Dr.Arthur Katz, if Dr. Katz would like to come up front and be ready next. Mr. Taylor.

Taylor: Good morning, Chairwoman Brown, other members of the Commission and staff. Thank you for the chance to come and talk to you. Just for the audience's interest, I think the reason I'm here is that Santa Barbara County, over the last few years, has issued a good deal of certificates of participation. There's been some controversy; our grand jury issued a report critical of it and so I'm, I think that's the reason I am here, sort of representing counties...

Brown: We thought you'd add a little color.

Taylor: Yes. It was a great relief, I should say, to find that I'm listed under the section of the agenda called "accountability of the public and investors," rather than under the section of "ability to pay." That is a big relief.

I think, some of my questions were similar to those that were posed to the last speaker and so I'm going to be able to be kind of swift with some of my responses because I don't want to be redundant. I do want to say just one thing, again, for the audience's sake. There was some reference before in talking about schools and talking about superintendents of schools and county superintendents of schools and that was kind of a use of the word "county" in reviewing the report from schools. Just so everyone knows, the county superintendent of schools is not a member of county government; it is a separate entity of local government; and the county has nothing to do with respect to reviewing the reports of school districts. It has its hands full reviewing its own situation, believe me.

Just briefly, in my background, I've been with Santa Barbara County all of four months, so I'm a real expert on the county. I have been county administrator for the last 11 years, 7 1/2 years in El Dorado County, 3 1/2 years in Solano County--both counties of which did issue a good deal of lease debt.

On to my specific questions. I was asked: What specific steps does your county take to keep itself from overcommitting its operating budget to lease expenses?

One, that the last speaker talked about, is the debt policy. I believe we gave your staff a copy of our county debt policy. If we did not, I'll certainly make sure that you receive one. That policy does set out the procedures for the county to review debt, the membership of the committee, the goals and objectives, what criteria will be considered.

I think it's important, particularly with respect to counties, that the Commission realize that, at least in our case, our advisory committee is made up of the county administrator, board supervisors, county counsel, and then very crucial, our independent elected auditor-controller, and our independent elected treasurer-tax collector. So there is a good deal of checks and balances in the nature of county government's structure and I think that reflects on the committee itself.

We have--as another step, we have taken to not overextend ourselves in this area--we have basically curtailed the practice that was loose management, I think, of department heads being able to enter into long-term lease arrangements that were lease purchase arrangements, on their own. And we had a situation where our data processing department had historically been allowed, through county policy, to do this as capacity of mainframe computers was approached. And that practice has been curtailed.

I would say, again, as the last speaker talked about a debt capacity study, the county has just recently, in fact, this week agreed to initiate a debt capacity study. It has also, just this week, agreed to retain a financial advisor and I think, lastly, probably the most important in terms of the real essence of this question is, our county staff is preparing a five-year financial plan for the board of supervisors. It's integrated into our annual budget process and it is a tool that I've used in the last two counties where I've been county administrator, and obviously, the whole idea is to do long-term planning so that one can look at your obligations in terms of these sorts of expenses and plan for them. And if someone wanted to look at our five-year financial plan for Santa Barbara County, it specifically identifies, as a line-item, lease financing debt as a separate item so it is clear to the public and so that we're keeping track of it as a major expense that we're responsible for meeting.

The second question I was asked to respond to was: What criteria does your county use when deciding to use general obligation bonds or a lease instrument for capital improvements? I think, you know, it's very obvious, that one of things that is done is some sort of test--and this is not scientific, believe me--as to voter support for a project. There are many needs of county government that are certainly not the most exciting to the public and in some cases, we feel it would be difficult in getting voter support. There are other projects where there is some voter interest and support. I think a project that has a great deal of controversy, would be one where I, personally, would at least suggest that there be a good deal of public screening, more than statutorily required to ensure public input.

Obviously, one of the crucial issues, probably the main one, is the ability to pay. Obviously, general obligation bonds carry with them the ability to have an additional source of revenue, whereas COPs do not, and so if an agency is on the line, with respect to operating expenses, COP issuance may not be advisable--so our committee considers that. We also look at such things as the cost of issuance, timing, those sorts of mechanical interests, I guess with respect to debt, in any case.

I believe one of the previous speakers mentioned rent conversion. It seems to me that where we are already paying rental expenses or service charges where we can convert those same funds into an equity ownership, that just makes good business sense and in that case, that's clearly one of our criteria. We would also rely on the advice of the financial advisor as far as helping us decide which instrument to use.

And, I suppose, the last point would be the degree of benefit. Some of our COPs that we have issued are for landfills, acquisition of additional property that are paid off by tipping fees or user fees at landfills. Some of these are not of general benefit to the county, but are very, very localized, so, in some respects, one of the things we are always looking at is who's really benefiting from this improvement and that would help us decide what mechanism to use to repay it.

The third question was: Do you believe there are circumstances where voter approval of lease debt is advisable and appropriate? I would say again, one situation where there's a good deal of controversy, there may be circumstances where that is appropriate. I believe very strongly in local government and representative government and I think people who are elected to local government offices are the ones who really have to measure whether there's enough controversy to seek public support. I think a good example of this would be the recent issue of the San Francisco Giants moving or not moving to San Jose--I think it's a good example where there was a good deal of controversy. Obviously, this makes a lot of sense, I think, to have voters voting on the financing related to that because of the long-term impact on the community. I think, thirdly, and related to this, would be the idea of whether the facility involved is a new asset to the community or to the agency that is not truly necessary for day-to-day operations, but is a new supplementary asset to the community. And it would seem to me, in a case like that, voter approval may very well be necessary, as well.

The third circumstance where voter approval may be necessary is where the COPs are going to be repaid through fees, but the fees are going to go up substantially. In other words, take this same issue that I was talking about with respect to landfills. If, in that case, the fees will repay the COP, but the fees are going to up 400 percent--there may very well be a circumstance where local officials would say, given that, we need to have a local voter referendum on the issue. So, I guess, ultimately, I would feel on this question that the people who are in the best position to make that decision on need for a local vote, would be local elected officials.

On, the last question is: What would be the consequence of prohibiting the use of COPs for capital improvements and requiring the county to seek majority voter approval of the COPs for noncapital projects that has been suggested by the Santa Barbara County Grand Jury?

I think there would be some very negative effects and I'll go through them real quickly. I think we would have potentially higher cost of doing business. In some cases, it actually is less expensive for a county or any entity to issue COPs, gain ownership interest, and not have to pay an ongoing rent or lease. So I think that it could increase costs, particularly if voters did not approve these issues. I think it would be a setback for republican form of representative government. I think we would have election costs that we don't have now that would be increasing. I think there could be a slowing in the decisionmaking process if we're trying to do these deals, in essence, trying to hit windows of opportunities for general elections or holding special elections. In any event, it would tend to slow business down. I think, in some cases, because some of these items are, let's face it, they're not the most exciting thing on earth to the public--you're going to buy a new mainframe computer and it's $2 million and you're going to pay it off over five years--is this the sort of grand policy issues the voters really should be asked to vote on and will they understand well enough to make a good business decision? I think the last point, and I think maybe we should all keep this in mind, in light of the Ueberroth Commission on Competitiveness in California, is the business climate.

Just looking at these charts here, these are all dollars, funds that, that reflect the buildings that have been built, equipment that has been manufactured and purchased. And given the state of the economy in California, I fear, frankly, anything that would occur that would tend to slow down and stop needed expenditures for equipment or facilities that, I fear, the voter approval might result in. I'd be happy to answer any questions you might have.

Brown: Thank you very much. Questions, Mr. Woods?

Woods: Yes. Thank you Madame Treasurer. Very quickly, sir, you're up here because of a problem in Santa Barbara, and you mentioned that the departments were issuing their own...

Taylor: No sir, I was talking about just lease purchase agreements. I think the controversy, with respect to our grand jury there, was certificates of participation, and whether or not the voters should be approving those or whether the board of supervisors should.

Woods: OK. That was the issue that's being considered in Santa Barbara, or was considered by the grand jury.

Taylor: That was the focus, yes sir.

Woods: Can you just comment briefly on that, do you have a view on that at all?

Taylor: Well, I would say that, with respect to this whole issue, it really kind of comes back to how much our local government decisionmakers are responsible for making local decisions and, and so I think my personal point of view, and the point of view of our supervisors, is certainly that responsibilities should be with local officials.

Woods: Very good. With respect to the problem that, about these accounting departments were authorized in, did that actually happen or, it seems, seems to me that to issue the COP, doesn't the board of supervisors have to sign off on this and doesn't that have to go through a process although the county might do all of the work? Just a brief response, we don't need to discuss it.

Taylor: Yes, sir. I can see that I've confused you by one sentence in my presentation. We had a situation where lease purchase agreements, not certificates of participation, totally different, separate instruments were being executed by our county departments as a routine part of their business.

Woods: That was a delegation that was given by the county supervisors to departments to do this, and the issue was whether this was proper? OK, were there any problems with those, with respect, were they done improperly?

Taylor: Correct, correct, correct. Not done improperly, but I think it comes back to this issue of ability to pay. The concern was, if county officials are entering to long-term lease purchase agreements, in essence, it builds in a wave of obligation.

Woods: A couple of other quick questions. It seems to me that... How long has this gone on? Any idea?

Taylor: I believe that, with respect to lease purchase agreements, it had been a practice from five to seven years.

Woods: Did your auditors ever pick this up? Could you comment it?

Taylor: To my knowledge, no.

Woods: How about the county grand jury? Do they ever...

Taylor: I haven't gone back and studied the grand jury personally, for the last seven years, but to my knowledge, there was no comments on that. And, of course, one reason, just so that the Commission is aware of it, is that the county, in turn, budgeted every year, as the board of supervisors considered the budget, that line-item, to pay for that lease purchase amount.

Woods: Very good. Thank you.

Brown: Any questions, Treasurer Merz?

Merz: Maybe just one comment. Your county, mine, and many others are developing debt advisory committees and I think that we'll see that those are helping in this type of situation. Do you think that maybe the expansion of those committees to be more open to have more openness towards the public would serve any purpose?

Taylor: It may very well and I, as an administrator, would have no problem with that. I think the first step is to see that everybody has one; and then the next step is the issue of who's on it and is it open or not. My bias would be that it would be open.

Brown: Very good.

Taylor: May I make just one closing remark?

Brown: Please.

Taylor: I could have easily been under a category called COPs and Politics, I think, because interestingly enough, the chairman of our grand jury, shortly after this report was issued that was critical in the county's practice, resigned from the grand jury and ran for board of supervisors.

Brown: Did he win?

Taylor: No.

Brown: OK. Well, my question was, was there any negative impact of the grand jury report? Or do you think it raised legitimate points?

Taylor: I think it raised--just as your hearing this morning is a very healthy step for us all to examine this--I think that the grand jury most properly looked into this matter and found some areas where they thought the county could do a better job. I think they, my own personal feelings, they went a little too far in recommending that the entire practice be stopped. I don't think that's appropriate, but I think, to the extent it caused public dialogue in the county, I think that was positive. To the extent that it drifted into the political part of our county's environment, that was probably not so positive.

Brown: Great. Thank you very much, Mr. Taylor. Dr. Katz, the Audit Chairman of the Nevada County Grand Jury. A grand jury from a different part of the state.

Katz: Thank you for inviting us to participate in the California Debt Advisory Commission's hearings concerning COPs in California. Our particular interest is an investigation that has been focused on the accountability to the public in the COP financing process, therefore, our response--which has already been discussed with the full panel of the grand jury--our response will be directed to your question that asks: What are the major concerns raised by the recent Nevada County Grand Jury interim report on the Nevada County Building Company and its use of COPs? What solutions has the grand jury identified to address these concerns? And for this I need to just give a very brief background.

I've referred to the Nevada County Building Company which I'll call NCBC. This is a nonprofit corporation that was organized 30 years ago to acquire buildings for the county through sales and lease-backed arrangements. Now this is the interesting part of it. Their board of directors is not elected. Their board of directors is not an elected board. It is a self-appointed group and they can seize or fill from within, from within a select group of friends and acquaintances. For the most part, they're a dummy corporation that is merely, what we have referred to as, a veil and a shell through which the county acts. NCBC negotiates agency agreements with the county and the county assumes the day-to-day operations and reimburses NCBC for any cost, any outlays.

The grand jury investigation has determined that the practice of financing lease-backs through COPs does, in fact, bypass the electorate in Nevada County, because of the fact that the directors are not elected, but self-appointed. The Board of Directors of NCBC has been characterized as civic-minded citizens, acting in the best interests of the community and there's no quarrel with that. They do mean to do good, as one of them said, but to whom are they accountable if they are not elected or appointed by those they are supposed to represent. They are an exclusive group, with no accountability to taxpayers for the public buildings they help to acquire.

The Nevada County Grand Jury believes that where the decision is made to add an additional tax burden, in one form or another--for example, even just increasing the interest payments as part of operating expenses--that it should remain in the political arena where voters have input.

Some COPs include operating expense items as well as capital financing, and the COPs then become a vehicle for deferring current operating expenses, which we would all agree is not sound practice. It is not sufficient, in a letter that I read from your Commission, saying that, well, there's always the opportunity to turn the rascals out. Any response to that is, it is not sufficient to rely on the referendum process to quote, "throw the rascals out," because by then, the taxpayers could be saddled with an unreasonable long-term debt. In the area of solutions, the grand jury's recommendation, included in the interim report, was that NCBC should be legally dissolved, especially in view of the fact that it's not directly accountable to the voters. And if such an organization were to continue, as a separate financing organization, it should include the board of supervisors as their directors.

Remember, the sole purpose of the grand jury is to investigate, recommend, and bring this information to light to the community. The grand jury itself, cannot enforce any action beyond moral persuasion. Of course, this leaves a loose cannon, capable of performing some great financial mischief, without the accountability; and, in fact, to date, the grand jury has not received a response, based on the March 5th interim report. We haven't received a response from the NCBC Directors or its legal counsel. So this grand jury in Nevada County believes that the voters may well be served by State intervention for voter and taxpayer protection. And, by State intervention, we're not saying the process should be eliminated, but we're saying we would like to see some enforceable body of rules and guidelines affecting the county, because we're talking about two-thirds of the COP issuance that we would be involved with, the public works part of it. And when you're dealing with the school districts, they have a mechanism that allows for a very tight review, but when you're dealing in the other area, we question some of the things we have seen happen in our own county. That really concludes my comments.

Brown: So, you'd like to see guidelines and what other specific recommendations would you like to see?

Katz: Essentially, it's guidelines that would be uniform throughout the state that would enable... We also want to see accountability, that the people who vote to use the COPs are accountable to the voters.

Brown: Be elected officials.

Katz: Be elected officials. In this case, they are not elected officials.

Brown: We appreciate your testimony. Do the Commission, other Commission members have questions? Thank you very much, we appreciate your input and your attendance here today.

Katz: Thank you.

Brown: The next speaker is Suzanne Finnegan, Managing Director for Financial Security Assurance. Welcome.

Finnegan: Good afternoon. Thank you. My name is Suzanne Finnegan. I'm a Managing Director with Financial Security Assurance. We're a bond insurance company in New York. I've been asked to address some specific questions of the Commission and the first focuses on the special risks of COPs and how credit enhancers evaluate and alleviate those risks.

Basically, all COPs have a unique risk in that payments are not absolute and unconditional. For annual appropriation certificates, the issuer can elect each year to renew the lease and, if they fail to renew the lease, they simply lose access to the project. For most California leases, the leases are subject to abatement and, therefore, have construction risk and the ongoing risk of the use and occupancy of the project.

Credit enhancers evaluate these risks by examining the essentiality of the project, the credit quality of the issuer and the risk of abatement. Specifically, though, I'd like to mention that in the past, credit enhancers have utilized asset transfers as a mechanism to offset construction risk which is generally not a risk we're willing to accept.

The second question focused on California COPs in comparison to leases that are issued in other states. Generally, I would say, in the past, California COPs have historically been viewed as stronger credits than COPs issued in other states, due to the strength of the covenant to budget and appropriate, as well as the long case history which supported the legality of the California lease structure. Basically, so long as the asset was available for the use of the issuer, the issuer was required to budget and appropriate, which compares to the annual appropriation leases where the issuer had an ability to walk away from the project on an annual basis. The California leases are riskier, in one respect, which is the abatement risk. However, this can usually be evaluated on a case-by-case basis and offset significantly.

The next question focused on the comparison of leases to other bond types and how they stacked up from an insurer's perspective. I guess, I think, all of us would agree that leases are a weaker security type than general obligation bonds in that you don't have an absolute obligation to pay, but I believe that they're stronger than many revenue bond types, where you're limited to a narrow revenue stream which may be focused on the existence of a single asset.

For essential purpose projects, with strong underlying credit, leases are insurable risks, which is evidenced by the size of the insured COP market. Insurers generally evaluate the outs permitted under the specific lease structure. Under annual appropriation leases, the risk of a failure to annually appropriate the rental payments is generally offset by the essentiality of the structure.

Under abatement leases, construction risk can be offset with capitalized interest or through the use of an asset transfer, and use and occupancy risks on a going forward basis are generally offset by the stringent requirements of the Field Act and other building codes, as well as an evaluation of the location and structure and type of construction of the structure.

The fourth question focused on what sorts of actions or structures could be utilized to enhance the credit quality of certificates. I believe that annual appropriation leases can be substituted as an appropriate structure when multiple projects are being financed. The use of multiple projects offsets the risks of the nonappropriation significantly, and the use of an annual appropriation structure eliminates the construction risk and abatement inherent in COPs today.

Secondly, I believe, in the current environment, we need a clarification of the true meaning of the covenant to budget and appropriate and whether or not that covenant is enforceable. I believe it would also be very helpful at this point to have a clearer statement from the State of their support of the COP structure in general and I think some of the speakers, today, have focused on that.

One other thing that I would like to bring up, is, presently, there has been a trend in school district financing, where the remedy to re-enter and relet a project has been unavailable in order to ensure that the school district would be able to receive States funds for school building. In the past, bond insurers and our company, in particular, have been willing to give up that remedy, due to the strength of the covenant to budget and appropriate. If the strength of that covenant is not enforced in the future, we may not be willing to give up that remedy and that may have an impact on school districts ability to obtain insurance for such financings.

Finally, I'd just like to make some brief comments on behalf of both my firm and behalf of AFGI, which is the Association of Financial Guarantee Insurers. And, basically I'd like to focus just on the Richmond situation. AFGI recognizes the unique features of the Richmond issue, particularly with respect to the deficit financing purpose and the credit quality of the district. We are concerned, however, about the State's broad response in its answer to the plaintiff's complaint. Specifically, our concerns focus on two main issues: One, is the denial that there was a duty to budget funds necessary to make the lease payments. This calls into question, the strength and enforceability of the covenant to budget and appropriate, which is a key factor in the insurance company's analysis of these issues.

Secondly, the response mentioned that the lease was void and unenforceable because it was debt without voter approval. This calls into question the legality of the COP structure, generally, but most specifically, the asset transfer structure. It's also contrary to the long history of case law which supports California COPs. On behalf of AFGI, we look forward to a resolution and clarification of these issues as the Richmond case unfolds. And I'd be happy to answer any questions.

Brown: Thank you very much. Are there any questions?

Woods: Just one, one question. As a New York bond insurer, could you comment or should I say, are you doing any reserving of these COPs when you issue your insurance policy, over and above what you provide? In other words, in your agreement, are you providing that the issuer also maintain a reserve fund?

Finnegan: That varies from issue to issue. That's a credit factor that we would determine on a credit-by-credit basis, but generally, on most lease structures, we require that there be a debt service reserve fund that's normally funded either through bond proceeds or through the purchase of a surety replacement for the reserve.

Woods: OK, but my question on that is, in terms of these COPs and the various ways that they come before you, do you have any guidelines or any suggestions that you could give to us in terms of what should be done as a base-line reserve requirement? I'm thinking mostly, because you issue--if I can expand a bit--you issue insurance and you issue your insurance for a fee, but you also set aside, I would think, in your calculation, a certain amount of your assets to insure this deal.

Finnegan: Yes, we're required to set aside capital to back up that guarantee.

Woods: Alright. Now, I'm thinking, in terms of what you're doing for the project, that same analysis, are you doing any of that kind of work?

Finnegan: No. Not, not specifically. We, we are required to set aside reserves of our capital base to support all of our guarantees.

Woods: Good. Do you impose that, superimpose that, again, on the project for, like, you know, we're talking about accountability to the public and investors, I just wondered.

Finnegan: Well, I think our fee is related. I believe that our fee is related to the amount of reserves that we are required to set aside, so in a sense, that reserve is built into the premium we charge.

Woods: OK, thank you.

Brown: Treasurer Merz, do you have a question?

Merz: No.

Brown: Let me just share with you, my concern about the so-called State's response in the Richmond case. I think, as I indicated in my preliminary comments to this morning's hearing, I believe firmly, as Treasurer, that certificates of participation and other lease-backed debt are appropriate forms of financing for infrastructure in the State of California and I was extremely concerned about the State's response in that particular case. So that's what we're about today: trying to articulate future action by the Commission and possibly by the Legislature, what may be guidelines for good COPs and bad COPs.

Finnegan: Thank you.

Brown: Thank you. OK, the next speaker is Jeff Thiemann, Director of Standard & Poor's, Mr. Thiemann.

Thiemann: Madame Treasurer, members of the Commission good afternoon. I am a Director of Municipal Finance for Standard & Poor's Ratings Group. Thank you first for inviting me here today to speak about municipal leasing which is a hot topic in the municipal market, not only here in California, but really throughout the country. We've seen remarkable change in both lease volume and the number of, and type of, participants. Recently, we've seen a lot of changes in the perception about the relative safety in investing in municipal lease obligations.

Annual lease offerings have grown from an estimated $2 to $3 billion in the early 1980s to about $10 to $12 billion today. Going back just 10 years, the public lease market really was a California lease market. But as the lease market volume accelerated, the number and types of participants expanded to other states and then to cities, counties, and school districts. S&P now rates municipal lease obligations in 37 states. California and its localities, however, still account for more than two-fifths of the $28 billion of lease obligations rated by S&P since 1985.

In determining lease ratings for transactions that are subject to, and dependent upon, appropriations, our approach is threefold. One, we start by assessing the general creditworthiness of the lessee. Two, we review the legal structure of the lease agreement. Key structural features that we evaluate include, the term of the agreement as it relates to the useful life of the project, debt service reserves, property upkeep, and insurance provisions and security interest provisions. Finally, we assess the essentiality of the project being financed, and a number of speakers have gone over this material. Depending upon the relative strengths, however, and weaknesses of the last two points, the resulting rating usually falls about a category below our senior credit assessment. The lease rating always falls below our senior credit assessment because lease payments are not absolute and unconditional. In most states, leases are only secured by a "best efforts" pledge to seek annual funding. Although California COPs carry a stronger covenant to budget and appropriate, payments are limited to available funds and the obligation is not absolute. One exception to this general rule are COPs secured by an installment sales agreement, usually on behalf of an enterprise fund, where payments are typically absolute and credit weaknesses in the revenue stream can be offset by additional coverage typically.

Despite the large number of issues outstanding and the lack of lease payment guarantees by governmental lessees, the repayment record has been extremely good. To date, actual defaults on rated and unrated lease transactions have been rare. Right now most lease investors and analysts are watching Richmond Unified's default on the unrated COPs. Recent bondholder, school district, and State actions have raised several questions with broad implications for leasing within the state. These include: whether the California covenant to budget and appropriate really provides extra protection for the bondholder; whether California law allows for the use of asset transfers for operating purposes, and even capital projects; and whether bond holder repossession remedies are, in fact, enforceable. The District and the State Department of Education's response to the suit brought by the trustee, on behalf of the certificate holders, raises serious concerns.

Recent media reports and some of our contacts have suggested that the challenge may center on the transaction's specific structure, which leveraged existing school property for operating purposes. If restricted to this narrow context, a successful invalidation of the lease would probably have only minor implications for the California lease market. Few transactions, particularly of the leases rated by S&P, fit this profile. S&P does continue to rate leases that are structured as asset transfers, given the state's long history of case law upholding the lease exception to the debt limitation. It is our opinion, that any successful attempt to invalidate leasing, in general, in California, is remote.

In addition to Richmond's default, leasing has been in the spotlight in the last year or two because of the near nonappropriation by Brevard County, Florida last year on a 1989 $24 million COPs issue. There have been rumblings about nonappropriation in a few other governmental lessees because of financial stress or project controversy and some very visible court cases, which have questioned the validity of lease-purchase finance as a statutory non debt alternative, specifically cases in Virginia, North Carolina, and Florida.

Investor uneasiness has also been affected by the use of appropriation backed debt to finance some nontraditional projects, such as the Texas Super Collider project; the dilution of bondholder security interest provisions in some lease transactions, and Suzanne just mentioned that in her testimony; and recent reports about unauthorized vendor lease financings, when, perhaps, those have been certificated out without the knowledge of the ultimate obligor.

It's understandable why all these factors have joined together to make buyers and sellers of lease securities take some notice, but if we step back and examine each of these headlines and consider the size and record of the municipal lease market, things don't look that bad. At S&P, we expect that some, but very few issues will run into trouble as a result of local political controversy, or financial stress, but we believe that defaults will remain rare.

A government has a lot to lose by walking away from a long-term lease financed in the public markets. Beyond the loss of the lease property, which is still usually the norm, the municipality would tarnish its name in the credit markets, which is not a wise move, particularly if the government plans to issue more debt in the future. Even if the lease issue is unrated, the municipality may be faced with rating downgrades on other rated debt transactions, including its general obligation bond rating. Its failure to appropriate and pay, raises questions about willingness to pay on other long-term obligations.

Let me conclude my remarks by noting that lease financing is not only a useful and flexible means of financing long-term capital, but it's really one of the only options currently available to many governments in California. Thank you.

Brown: Thank you. Are there questions from the Commission members?

Woods: Just one. I asked the same question of Moody's. Do you rate COPs to finance operating costs?

Thiemann: And I'm going to have to hedge that a little bit because I think what we would have to do is look at the facts of the case. There's no blanket rule that we would not, although, with the Richmond challenge out there, we would probably shy away from California COPs for operating purposes. When we're asked to rate a transaction, what we are reviewing is the specific security behind the transaction and that would annually be a covenant to budget and appropriate for use of, hopefully, a very essential asset. And if we can evaluate the fundamental creditworthiness to be creditworthy, then potentially, we could rate the transaction. But in a situation like Richmond, the fact that they were issuing COPs to fund an operating deficit, was a leading indicator that the fundamental creditworthiness is weak, and, therefore, we probably wouldn't rate that transaction investment grade.

Brown: Mr. Merz?

Merz: No.

Brown: Let me ask you the same question that I asked the representative from Moody's. How would you view the State's credit, if the State were to step in and bail out a defaulting school district, or local government entity?

Thiemann: Again, I think we would have to, we would have to see exactly what the situation was on that, if there was some kind of a precedent established that clearly we could view the State's own burden to be slightly different than we view it today. As the respondent from Moody's suggested, you know there could be a little bit of a trade-off there. Clearly, local governments are going to, perhaps benefit if the State implicitly stands behind all its obligations, but maybe the State would not.

Brown: So, in the event that the State stepped forward to provide relief, it has potential implications...

Thiemann: It has potential implications. I think you really have to look at it on a case-by-case basis. The State has set up all these other mechanisms to try to avoid being placed in the situation where it would be called upon to do that.

Brown: But there is a value to the State's credit to withhold that kind of...

Thiemann: Commitment?

Brown: Commitment.

Thiemann: Absolutely. The additional obligations on the State, in addition to backlog of voter-approved issues... Clearly, the debt issue in the State of California is one that we're watching and any implicit additional responsibilities could be a factor.

Brown: But, with respect to the State's current outstanding debt issuance, we are still, in your judgement, well within the prudent ratios?

Thiemann: Yeah. I believe that's the case. I know you've talked with Steve Zimmermann of our office and he's sort of...

Brown: Would you consider three percent of general fund revenues dedicated to debt service, prudently within your standards?

Thiemann: Three percent of General Fund at a state level? For most states, that's usually a prudent level. That number really varies, state-by-state, given the different obligations that are funded at a state level versus funded at a local level--so there are not any magic numbers that we can offer, but what we would do is examine each case.

Brown: But three percent is the general rule.

Thiemann: Three percent sounds reasonable. Again, I'm not the primary analyst on the State of California so...

Brown: Get comfortable with us. You can give us a direct yes or no answer. Don't worry about it. Zimmermann's not here. Is Zimmermann here?

Zimmermann: Yes, it's OK.

Brown: It's OK. Alright?

Thiemann: He says it's OK.

Brown: He was letting you have a little trial up here. I didn't see him back there. Good. It's OK.

Thiemann: The point is, it's really a case-by-case analysis.

Brown: I think he did well. I think you should give him a raise.

Thiemann: I like that.

Brown: He avoided the question with style, grace, gave us a little hint. So you didn't want to testify. You thought I might ask you some other tough questions, Mr. Zimmermann, huh?

Zimmermann: I know my limitations.

Brown: OK. I think you've answered my question. Thank you very, very much and a little light relief after all of the speakers. We appreciate your coming today.

Thiemann: Thank you.

Brown: The next speaker is Murphy McCalley, Finance Director for San Diego MTDB and Keith Curry. Is Keith here too?

McCalley: No, he wasn't able to make it.

Brown: Good. Well, we appreciate your coming and welcome.

McCalley: Thank you. My name is Murphy McCalley. I serve as the Director of Finance and Administration with the San Diego Metropolitan Transit Development Board, which is quite a mouthful in and of itself. I also, I'm here representing the California Transit Finance Corporation, which is a nonprofit corporation, which was created in 1990, to assist transit agencies in the California area, in the State of California, in issuing certificates of participation. Specifically, for these types of transactions--this particular type of transaction I'm going to be speaking about, is one in which federal funds are used as a revenue stream to make the lease payments that are required under the COPs. Both in my capacity as the Director of Finance and Administration with MTDB as well as with the CTFC, I have been involved in some $200 million of certificates of participation which have been issued under this particular structure. Today, I'd like to just talk about some of the benefits of that particular structure--how it is helping facilitate in meeting the capital needs of the many of the transit agencies in the state.

The use of COPs, obviously, is not a new concept. However, it was new for the federal government, particularly the Federal Transportation Administration, with regard to allowing transit agencies to utilize federal funds to make debt service. Under the Federal Transportation Surface Act, in the past, agencies were only allowed to utilize federal funds to pay 80 percent of the principal portion of a COP issuance. In 1990, they reversed those regulations and provided for both principal and interest to be paid for utilizing federal funds; and it was that particular twist that then made the issuance of COPs, and utilizing federal funds as a source of repayment, more attractive for transit agencies in that regard.

Essentially, the way these federal funds will flow in, is that there's typically a local match requirement. There's an 80 percent contribution from the federal government and a 20 percent contribution which is made up of local funds.

Prior to this regulation change, transit agencies were required to either 1) accumulate their grant, which is held by the U.S. Treasury until such time as one had enough monies to go out and acquire the asset or build a facility, or 2) they would break up the segment, the procurement, into different increments equivalent to the amount of Section 9 federal funds that they had available. With the issuance, with the change in regulation, it now allows agencies to accelerate the acquisition of equipment, particularly buses in this case, utilizing this particular approach.

In addition to that, one of the benefits that we've seen from this type of approach, is also that we were able to better cash manage our local match. I mentioned that there's a 20 percent requirement for each one of the agencies as part of the federal grant. We are now able, through utilizing COPs, to better utilize these local funds that we currently have through investing those monies during the time of the duration of the COP transaction. So it's an efficient use of our local funds as well.

I'd like to just touch on, quickly, some of the transactions that have transpired which have utilized this particular approach. Back in 1990, MTDB was faced with a situation where we needed to replace 130 buses. This far exceeded our amount of allocation that we received from the federal government. We then looked at the notion that it would take us some 4 1/2 to 5 years to acquire all this equipment, and with the new regulations in place, we began to look at the COP structure as a way to meet that need. Based on that approach, we issued some $41 million in certificates of participation and realized a present value savings of some $4 million in that procurement through avoidance of inflation if we were to string that procurement out over 4 years, 4 1/2 to 5 years.

Brown: That's net after costs.

McCalley: That's net after costs, correct. In addition to that, there were other benefits as well. There was reduced maintenance costs. We also were able to acquire more environmentally sensitive equipment in replacing some of the old diesel buses. We were able to get particular transit equipment. So there were many, many benefits associated with this transaction. But one of the bigger benefits, was our ability to leverage our federal funds that now can be utilized for other projects. In affect, were we to go on a pay-as-you-go basis, we would be utilizing all of our federal funds to meet our bus procurement purchase. Under this structure, we would only need to use a portion of our annual allocation to make the debt service with the remaining piece now available to apply for other projects. So, in effect, we were able to leverage our federal funds, to not only meet our bus needs, but also meet some of the other needs that we had in our particular community.

Just recently, in January, Sacramento Regional Transit Agency issued some certificates of participation using the same structure. Those certificates were sold under the California Transit Finance Corporation and they issued some $43 million in certificates of participation to buy 75 compressed, natural gas buses. They also experienced a savings of about $4 million through that particular approach and, in addition to that, were able to realize or free up, in effect, some $40 million in federal funds that they now can apply towards other projects as they proceed.

And just yesterday--just Tuesday--the Los Angeles County Transportation Commission just issued some $115 million in certificates of participation on behalf of the Southern California Rapid Transit District. This is to acquire some 330 buses, most of which are methanol buses. This will allow them some $81 million in funds that they can use towards additional projects by freeing up those federal funds that would have gone primarily to just buy those equipment.

So what are the advantages of this approach, particularly as it relates to the transit agency in utilization of the federal funds and the issuance of certificates of participation? I mentioned the notion of leverage. One of the things that I think that we have been able to quantify is the fact that for every dollar of COPs that we've been able to issue, we've been able to generate $1.84 in spending capacity through our utilization of those other federal dollars that could apply towards other projects.

So you can see there's many benefits, I think, that we have been able to glean from our approach in utilizing the certificates of participation. Specifically, some of the questions that you asked that I respond to was the spread differential and as it relates to whether it was a pledge of general funds versus federal funds. The way that we were able to structure the transaction, in effect, is that this is a pledge of the general funds of the various transit agencies. The use of the federal funds, I think, just enhances that, if you will.

We are required, obviously for rating purposes, to identify other funding sources that could be available in the event that federal funds are reduced or eliminated. So, therefore, the way the transaction is structured, we identify several other funding sources, in addition to the federal funds, although the federal funds are the primary source of repayment that are being proposed. And it's through that approach that we've been able to achieve A1/A+ ratings for the various transactions which have been closed. And based on those transactions, we have been able to minimize any differential that may exist between COPs and say, just a straight revenue bond, if you will. In addition to that, we've also structured the transaction in an installment sale structure, which eliminates the notion of a rental abatement, so we try to again allay the fears, I think of bondholders with regard to those kinds of issues associated with COPs. And I think it's through that structure that we've been able to accomplish the types of ratings that we've been able to achieve.

You asked about additional cost. We've been able to achieve these ratings without any enhancements whatsoever--insurance or letter of credit--and so we feel that what we've put together is a very strong package to really enhance the security of those particular certificates.

And last, but not least, you've asked: Could other agencies use it? Clearly, it is something, I think that the transit agencies or the transit industry, rather, is certainly taking a close look at. There's now been three transactions done in California. We anticipate there will be more. I have gotten interest from transit agencies throughout the country for that matter about this particular approach. As you can see, there are many benefits to it as well if used in a prudent fashion. A lot depends on the nature of the federal funds that the agency receives, and what are the limitations associated with those funds. In the case of transit agencies, I think the agencies have been pushing for the federal government to relax its restriction on the use of those funds in a lease transaction and it was through that relaxation, that allowed us to now take advantage of this opportunity. And as a result, the federal government, has, in fact, been encouraging transit agencies to utilize this particular approach to leverage its monies for, not only acquiring equipment but for building needed facilities in the transportation area.

Brown: Terrific. Thank you very much. Any questions?

Woods: Just a couple, Madame Treasurer. Mr. McCalley, is that light rail operation within your district down there?

McCalley: Yes.

Woods: Just, I appreciate your testimony, but I, I just have to ask you this, what ever happened to the old fashioned trust certificate, where you bought things, and you, and you put the little sticker on the side of the train or the bus and says, "this belongs to the Bank of America" and then you pay it out, like an installment sales contract? Is that still around any more?

McCalley: I'm not aware of it.

Woods: It's an old, old time way that you...

Brown: Now, Mr. Woods, don't date yourself here. I've never heard of it. Have you, Don?

Woods: Well, you know...

McCalley: I am familiar with the concept. I have not heard it in recent times, but we can bring it back.

Woods: I mean, when I took finance, well anyway, I'm sorry. I appreciate your testimony.

Brown: You know, it may be an idea that, whose time has come again.

Woods: Well, I was just thinking about that when you said that this includes net/net cost. I was thinking, do you mean, also, that had you structured it so it was, in essence, an installment sales contract where the financing entity takes the, the rolling stock actually belongs to whoever that may be, Bank of America or whatever and they actually put a little sign on it somewhere that says this is the property and you use it; you pay it off; and there's a certain cost to that, obviously. And I just wondered, is that just gone by the way of the, well you can't say the buffalo any more?

McCalley: Well, I think that the concept is the same as with the COPs.

Brown: Same concept.

McCalley: I think the way we 've structured it, in effect, is just what you described.

Woods: Yeah, but with the COP, though, are you doing it with the rolling stock or are you pledging other property?

McCalley: No, it's with the rolling stock. There is a lien on the equipment.

Woods: Oh, so it's a lease-purchase.

Mccalley: It is a lease-purchase. There is a lien on the equipment.

Woods: I see, I see, I see. Very interesting. Very interesting presentation.

Brown: Thank you.

Merz: Just a clarification; you've done COPs for primarily equipment, rolling stock--you haven't really attempted to go for longer, like the light rail or something where you'd finance. Would the federal government look at longer-term projects any differently, do you believe?

McCalley: Not at all. I think that the only sort of limitation, if you will, would be the notion that under the Federal Transportation Act, there is a limitation to the actual Act itself, which will expire in say five years, and so there is that potential risk of the Act being reinstalled, but again, we think that that's sort of minimal given the track record of the federal government in regard to funding transit.

Brown: That was really my question: Is the source of federal funding vulnerable to any budget cutting, and if so, how does that affect the security?

McCalley: It certainly is, and I think that that's one of the reasons the rating agencies have required that we identify other funding sources in addition to the federal funds, and they sort of take a weak link approach to rating that. And so, I think that one of the strengths that we try to provide in each one of the transactions is sufficient other funding sources, that again we would prefer not to use, obviously, for that payment but nonetheless, would be available to use.

Brown: You're willing, you've been willing to make that commitment. Terrific. Thank you very much Mr. McCalley. The next speaker is Russell Lombard and following Mr. Lombard who is an attorney with Arnell & Hastie, it will be Robert Williams and then public speakers. We have one. Anyone who wishes to sign up, please do so over here. Welcome.

Lombard: Thank you. Good morning. My name is Russ Lombard and it's true I'm an attorney with Arnelle & Hastie, but I'm here in the capacity as President of Transocean Funding, which is a lessor for-profit corporation and with me is my colleague, Josh Cooperman, who is here.

Brown: I'm sorry, what was the name of your firm?

Lombard: Transocean Funding.

Brown: Oh, Transocean Funding, sure.

Lombard: And we were a consultant to the CDAC on writing of the primer...

Brown: Right, right, on leases.

Lombard: ...on leases and I was asked to comment upon the cost-effectiveness of COPs, in terms of general market, and my perspective is really from the perspective of a for-profit corporation and not from a nonprofit. I can only enthusiastically say that COPs, in terms of its structure and in terms of its benefits to the particular State agencies and entities that use it, are manifestly manifold.

Specifically, we, in our experience, have encountered situations where, because of a COP structure that we've used we've been able to save counties money; where, then they could use that money to save the job of somebody who works in the MIS department, and I won't mention the counties or the particular agencies in mind. We find ourselves in a particular niche wherein the cost-effectiveness of using COPs reduces the debt service costs of the particular agency or county or whatever municipality it is. It allows us to go into the market and provide a clearly desired investment. We are able to work with, and continue to work with the agencies, in terms of the ratings in both unrated and nonrated situations and in rated situations, and because of those savings we're able to project from what we were three years ago to about $100 million worth of business so far; and there's a deep need to do the things necessary to make sure that government continues. I think that the structure of the COP is such that it is so flexible, that you basically can finance just about anything over particular times, so long as the essentiality requirement is there remaining and that the general life is there remaining.

I don't really have any other general comments to make and I will try to address some of the specific questions you've raised as it relates to the Richmond Unified School District and other issues that are associated.

I was asked specifically whether or not I would consider getting involved with raising money for the Unified School District given its present situation of lawsuits and so on.

Brown: But not by CDAC.

Lombard: No, no. No, no. No, no. This was by my colleague Mr. Cooperman who's seated with us today. Not by CDAC or a State agency. We were theorizing as to whether or not the flexibility of COP was that flexible under it's present situation. And my general answer was basically contained in comments made from the gentleman from S&P, and that is, that you look at the creditworthiness more than anything else and our experiences with our investors has been that they look at that as well. We're not talking about unsophisticated people and so long as you disclose entirely the debt source--the entity with whom you are dealing--we found that there's a great resonance of being able to sell these on the market and also to raise money thereby. And, I really have no further comments that haven't been already been treated by other people.

Brown: Very good. Are there questions?

Woods: No questions.

Merz: No.

Lombard: Thanks.

Brown: Thank you very much. The last agenda speaker is Robert Williams, Vice-President, Sutro & Company. Mr. Williams.

Williams: Thank you very much. It's a pleasure to be here. My name is Robert Williams. I'm a Vice-President with Sutro & Company. The topic is the gas tax certificates of participation and overall cost-effectiveness and I would like to just move quickly to the questions that the Commission has asked that we address.

The first questions is : What advantages are there to using state fuel tax COPs to support local transportation improvements? I think the speaker from MTDB mentioned some of those. Basically, you provide the opportunity for upfront funding for street projects which often times are more efficiently constructed up front rather than phased, and this will provide you some economies of scale with respect to your construction management. Alternatively, if you were to phase this, what you would have to do is, you would have to bank that money until you had enough money to proceed with your project. Right now you have a situation where, if you are banking that money, you'd be earning, you know, in some cases four or five percent. The question becomes, are the cost of those improvements escalating at a cost that's higher than your reinvestment rate? And if the answer is yes, then this program provides a fairly effective inflation hedge. So basically it comes down to a cost-benefit analysis. Does phasing cost you money? Can you achieve economies of scales and are your cost of construction exceeding the reinvestment rates for banking this money? So, I think those are the primary advantages to doing this gas tax COP program.

The second questions is: Can you provide an estimate of the savings in using this type of COP versus one which would be backed by a local jurisdiction general fund? The program that we developed was for the City of Fresno and the City of Fresno issue received an A+ rating by both Moody's and Standard & Poor's. I think maybe, coincidentally, that's the same as their general fund lease rating, so these COPs were, in essence, marketed the same rating and the same credit quality as their general fund, but it's a little bit more complicated because the structure of the COP was considerably different than a lease.

First of all, we had an installment sale contract. The issue was not subject to abatement and the streets themselves were not put up as a collateral asset. We had very strong coverage, with respect to the gas tax revenues. With this issue, it was in the range of, with this particular issue, it was four to five times what the annual revenues were, which is very, very strong. Additionally, we put an additional certificates test on this issuance of additional COPs and that's not something that you can normally do with a general fund type obligation. Finally, we had covenants regarding the flow of funds to the trustee to make sure that the payments were available to the investor on a timely basis.

I think the question ultimately becomes, if we apply the structure--Fresno, for example, is a AA rated G.O. city--the question becomes, if we do this transaction for an A rated city and we utilize this, do we get an A+ rating? And I have to say that, you know, it hasn't been done, and so, until we have a clear track record with other cities, it is a little bit difficult to answer that other than that brief discussion.

What type of improvements can be funded using this form of financing? Well, basically this is for street improvements and transportation projects. The types of improvements are spelled out in the Streets and Highways Code. It's engineering construction, right-of-way acquisition and the incidental costs associated with the construction of these street improvements and, again, these are spelled out in the Streets and Highway Code, relative to the use of gas tax revenues in general.

The third question is: Can most jurisdictions which receive State fuel tax subventions participate in this type of COP program, or is it limited to those with significant annual subventions? Well, to cities, this is a population-based subvention. So, smaller cities obviously are going to be at somewhat of a disadvantage in terms of leveraging their funds because they don't have as large a subvention as the bigger cities or the larger counties. There are ways for them to participate. Pooling is one way to do this, and, you know, then it just becomes a question of how much revenue can they raise and the overall cost-effectiveness of issuance.

I think there's a couple of other questions, though. There are two requirements to receive the Prop. 111 gas tax revenues which are maintenance of effort and congestion management and clearly, whether you're a small jurisdiction or a large jurisdiction, you have to agree to comply with those. Maintenance of effort has proved to be a problem with a lot of smaller jurisdictions and they've expressed this as a problem.

Brown: Do they covenant to that end as part of the bond document?

Williams: Yes, they covenant. They covenant to meet all the provisions of the Streets and Highways Code to receive the Prop. 111 funds and the two most important are maintenance of effort and congestion management. And actually, you know, we have talked to cities, you know, they're faced with making a $2 or $3 million appropriation to meet MOE and are receiving $300,000 or $400,000 subvention and it becomes a difficult question.

The final question is: What would be the advantages and disadvantages of issuing similar structured revenue bonds which relied on fuel tax proceeds? This was not a revenue bond. It was subject to budget and appropriation, specifically from gas tax revenues. What was certificated out was an installment sale contract. I think, in general, a revenue pledge is stronger than an appropriation pledge, assuming that you have a sufficient revenue base. I think that's clear. I am not going to speak whether it would improve the rating. I think you can ask the rating agencies. It's possible, that given the same coverage, you might have received a better rating, or conversely, you might have been able to reduce the coverage.

Brown: Thank you. Now we go to public testimony. Please limit your comments to three minutes. The first is Steve McClure and if he would just identify who he represents. We welcome you.

McClure: I'm Steve McClure with Capital Guaranty Insurance Company. We are bond credit enhancer based in San Francisco. Specifically, with regard to lease financings, we continue to be active in that market. We view the potential as stable despite current events, although we, we have reluctantly suspended insuring asset-swap transactions.

Specifically my point pre-dates the current events and goes to the State's change of position, I guess, a year and half or two years ago, on subordinating their interests in projects jointly financed with COP proceeds and State money. We do not insure these transactions although we like the concept with leases, but we have a real problem getting over the hurdle of, on one hand saying the most important thing is the essentiality of the project and on the other hand, knowing going into the financing that we don't have a chance of ever being able to relet the project that is subject to the lease. And we view that as inconsistent internally, and as a company policy, we have suspended insurance of those particular financings. And we would urge the powers that be to suspend the practice of not subordinating, so we can participate in these markets because we want to be active, but we can't be. And that's the extent of my comments.

Brown: Thank you. Is the representative from the Department of Education still here? I think he left. We'll let him know. Mark Epstein, California Financial Services.

Epstein: Thank you very much. I am Mark Epstein. I'm a Managing Director at California Financial Services. We are financial advisors, but our specialty is school facility planning and financial planning at the school district level.

In 1989, I had two meetings, at the request of officials from Richmond Unified School District, to discuss underwriting a second COP financing for between $9 to $12 million. It was obvious to me, at the time, that the district didn't have the capacity to fund its first loan, much less the second one and I told them so. In fact, I created a simple budgeting model that accurately predicted the very fiscal outcome that is in no small part the reason that we are having this discussion today. And yet, knowing the financial ledge upon which they were perched, these school officials borrowed more money from IBM when Wall Street said no, and Wall Street did say no. My company said no and so did other firms that I am aware of.

I'm here today, to say that Richmond Unified School District, a district that first borrowed long-term money to fund short-term operations, and second, borrowed more money, when it was clear that the first loan could not be repaid, is not typical of school districts in the way that schools use certificates of participation.

The rise in certificate of participation issuance is in some measure, the result of the converging economic factors which make pay-as-you-go less feasible: explosive residential development accompanied by a sadly inadequate statutory impact fee; a school building program that falls further and further behind the tidal wave of new children in our state; unfunded interim housing costs and year-round education costs while districts wait in line or abandon hope for permanent schools; cost-of-living adjustments that don't keep pace with inflation; combined with vendors, utilities, and teachers that often insist that they do; local communities that reject bond measures twice as often as they approve them. So future school districts borrow against future developer fees, tax increment revenue sharing, and even the general fund to pay for air conditioning units for year-round education; for relocatable classrooms to be placed on existing school sites; to pay their 50 percent share to qualify for "priority one" at the State Allocation Board; and to pay buses, computers, school furnishings, and a variety of equipment.

I'd like to share, in my remaining time, some of the positive uses of certificates of participation from just among my clients. Riverside, Chino, Grossmont, and Perris School Districts have stopped using expensive vendor supply financings at rates as high as 16.9 percent for relocatables, computers, kitchen equipment, energy management equipment and the general office equipment. Instead, they have brought their financing cost below 7.5 percent, saving their communities hundreds of thousands of dollars. This substitution of publicly issued COPs for vendor financing is part of the 71 percent growth in the uses of publicly issued COPs at the school level.

Hemet, San Jacinto, Central, and Moreno Valley School Districts issued COPs under the State's Interim Financing Program in anticipation of being reimbursed by the State Building Program, once the recently approved bonds are sold. They are currently on the list to be repaid as are other districts that borrowed under the $500 million Interim Financing Program cap. They are also part of the 71 percent increase. Moreno Valley, San Jacinto, and Riverside Districts refinanced COPs from the 1980s taking advantage of today's lower interest rates. Even while reducing their debt burden, they, too, count towards the 71 percent increase.

Lodi and Moreno Valley recently purchased office buildings and thereby reduced their cost for office space, saving money, but also counting toward the 71 percent increase. And, finally, Temecula Valley, Chino, San Jacinto, Eureka, Riverside, Moreno Valley, and Rialto School Districts used certificates of participation to buy future school sites while prices are depressed, and sellers are willing, which most recently saved the State Building Program over $2 million on a single site; and which promises to save the State and local districts millions of dollars in the years to come. And, yes, these too count towards the 71 percent increase.

These financings represent the strategic use of COPs to reduce costs and to match capital cost to the expected life of long-term capital facilities and equipment. There are legitimate uses for COPs and there would be COPs, even in an ideal world, although today's financial world is certainly less than ideal.

Can school districts support this new debt? In the short-term the answer is "yes." Though they may commit much of their developer fees, tax increment, and other capital money to do it, school districts can generally afford what they are borrowing. In the long-term, the fiscal future lies outside the control of local officials and whether the State fashions policies that keep pace with inflation and recognize capital and operating costs that flow from policy making or, alternatively, whether districts are allowed to slowly strangle from a combination of unfunded policies and a school budget that declines in real dollars per student. If school districts can be kept economically healthy by the State, they'll easily meet their modest obligations to investors. In the meantime, they will need COPs as a tool for adaptation to this period of uncertainty. I thank you.

Brown: Thank you very much. Any questions? We appreciate your input.

Well, I think you've had a very thorough airing of the variety of issues that certificates of participation and other lease-backed securities raise, and we could summarize some of the points that we've heard today. I think the top line, for me, is that COPs are essential as a financing tool for improvements at both the State and the local level, and that any legislation which would seriously handicap the use of this financing tool would be quite damaging to local as well as State finance, which is not to say that there aren't improvements that can be made.

I think, in addition, we heard that California COPs are notable for their ability to covenant to budget and appropriate, and that this is a strength of California COPs and should be protected.

On the other side, I think what we heard was that Richmond Unified School District, while having had an impact on the California COP market, appears to have had somewhat of a marginal impact, and largely limited to school district COPs. This could change, however--I think we heard quite clearly--if the line of reasoning adopted by the Department of Education in the Richmond case, or at least a portion of that line of reasoning is upheld.

Next, asset-transfers were commented upon and appear, from the speakers' response, to be fundamentally and legally sound elements of a lease structure, as long as the asset being financed is a capital improvement or some other form of long-term indebtedness, which while being nontraditional, is supportable by revenues, ability to pay, and the like.

On the disclosure item, COPs disclosure is considered, from those who have spoken today, to be generally sufficient and we have seen in recent issues the impact of both the Richmond decision on disclosure as well as Prop. 13--but now we don't have to deal with Prop. 13.

The school district issues that we heard about today include positive comment, generally, on AB 1200. While not a perfect tool, it sounds as though it promises to ensure more appropriate lease practices for school district financing and it is a good tool to protect against troubled COPs and troubled leases.

I think I heard from just about everyone who addressed this hearing a strong, strong support for majority vote approval of local G.O. bonds--that that would be beneficial to local governments. I certainly believe that this is the case and actually would hope that it would possibly be incorporated into any budget compromise that is adopted in the next few days.

I think that we can all agree that school business officials are professionals who are dedicated to sound financial principles and are facing incredible pressures to meet the needs of the students in their districts.

On the subject of accountability, the development of debt policies is really needed. It's being done by a number of local agencies, but, perhaps, action by CDAC in this area would include various debt guidelines. Debt management and debt affordability guidelines are tools which would be helpful for local issuers in both the COP and lease issuance area. I think its important to note that when I came in as Treasurer I insisted that lease-backed debt and general obligation debt be considered together in order to determine the ratios that the rating agencies use for prudent debt management. Previously, it had been separated, with G.O. bond debt over here and lease debt not considered as truly a part of the State's debt obligations. I think it's critical that we include all of the debt of the State.

I think we heard general support for the desire to have the public more involved in the issuance of COPs and lease-backed debts so that they understand and appreciate the challenges that local governments and local school districts face in trying to serve the public and how intractable the problem is to find the dollars and resources and tools to meet those needs, particularly for capital costs. So, while involvement of the public is thought to be critical, I think that we did hear that representative government is another key element of our democracy and that we should leave many of these decisions, as a delegated matter, to the representatives elected by the people. We did hear that there are problems that emerge when you have a nonelected body that is not accountable to the people making some of these long-term commitments for the taxpayers and citizens of local communities. So, I think, addressing that issue of accountability should be a part of any kind of guidelines we adopt as a body.

Cost-effectiveness, I think we heard over and over again that actual defaults of COPs are extremely rare--extremely rare; I want to reiterate that. In fact, a narrow interpretation of the Richmond case would really limit the impact on the California lease market.

Some of the positive developments we heard about today in the California COP and lease market include the use of federal funds to meet debt service of COPs, which finance transit improvements, which has resulted in significant savings to transit districts that have utilized them. COPs have been important and instrumental in reducing debt issuance cost and their flexibility is to be protected in order to maintain that virtue for local issuers.

We heard about the gas tax COPs and how they can be used to provide up front financing on street improvements, which avoid inflationary costs for the taxpayers and that is a plus for COPs in terms of cost-effectiveness.

I think this hearing has certainly provided me, as the Chair of the Commission, and hopefully to the members to the Commission, as well as those who have attended, with a very sound and thorough understanding of many of the issues that have been raised in the press and in the public's mind, and certainly in the rating agencies and the investors minds, about the California lease market.

CDAC will continue to take testimony through written comments delivered to the Commission through June 30th, and we will then provide a report to the public and address any recommendations that may come out of this hearing.

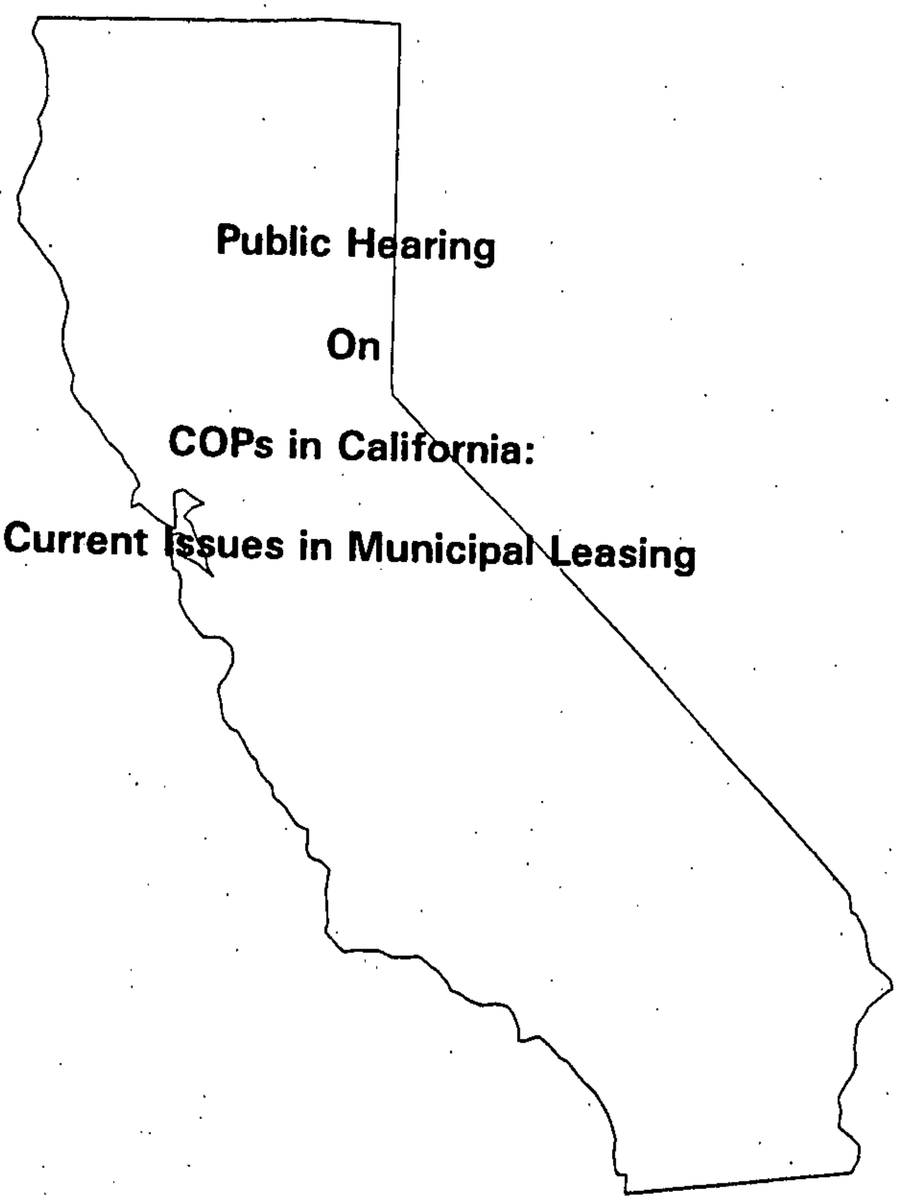
I think an enormous thanks needs to be given to Steve Juarez and to his staff from CDAC, who are here, who have made this hearing so informative and helpful for the taxpayers, citizens and governmental agencies in California, so thank you to you, Steve and to the staff of CDAC. And a very large thank you to all of the speakers who prepared for this hearing and were so responsive to the questions that we put to you, as well as bringing forth your own additional thoughts and ideas on the lease financing for infrastructure and capital needs in the State of California. Are there any additional comments from the Commission members.

Woods: No. Very good summary.

Brown: In that case, I would adjourn the special meeting of the California Debt Advisory Commission. Thank you all for coming.

Section III

Written Comments



Public Hearing

On

COPs in California:

Current Issues in Municipal Leasing

Oakland, California
June 18, 1992

SECTION III

WRITTEN TESTIMONY

The following persons presented both oral and written testimony at the hearing. Their oral testimony is included in *Section II, Oral Testimony*, and their written testimony is on file with the Commission.

R. Mark Epstein, California Financial Services

Stan Wolcott, California Association of Bond Lawyers

Stuart Greenfeld, State Department of Education

Jeffrey J. Thiemann, Standard & Poor's Rating Group

Sandra Lee Lemmons, Modesto City Schools

David Brodsly, Moody's Investors Service

Barbara A. Lloyd, Leifer Capital

Rick Hiscocks, Orrick, Herrington & Sutcliffe

John Pizzarelli, Association for Governmental Leasing & Finance

RPR

RAUSCHER PIERCE REFSNES, INC.

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June 22, 1992

Ms. Kathleen Brown
State Treasurer
State of California
915 Capital Mall, Room 110
Sacramento, CA 95814

Mr. Steve Juarez
Executive Director
California Debt Advisory Commission
915 Capital Mall, Room 400
Sacramento, CA 95814

Re: California Debt Advisory Commission Hearing
COPs in California: Current Issues in Municipal Leasing

Dear Kathleen and Steve:

On June 18 I attended the hearing in Oakland sponsored by the California Debt Advisory Commission on the subject of COPs in California. The background paper was well researched, and I want to take the opportunity to add my comments based on my experience of serving as financial advisor or managing underwriter on over 30 lease-backed issues in California totalling over $ 600 million since 1983.

I strongly recommend that the State Legislature approve ACA 6 for the November 1992 ballot so the California voters can have an opportunity to decide if local general obligation bond issues can be approved by simple majority vote.

I further recommend that the State Legislature enact legislation to establish a State sponsored intercept program patterned on the Motor Vehicle License Fee guarantee program covering State subventions to K-14 school and college districts and other State subventions to cities, counties and special districts.

I recommend that the California Debt Advisory Commission accept the challenge of providing technical assistance to all local entities regarding establishing policies regarding debt issuance and administration, operating, insurance, and capital fund reserves, and five-year capital improvement plans.

Lastly, I caution the Commission or the Legislature from defining an acceptable level of annual capital lease obligations as a percent of the operating budget. Many "general fund" lease obligations are actually carefully structured as self-supporting obligations. Local public entities have "earmarked" parking system revenues, tax increment, developer fees and many other revenue sources toward payment of annual lease obligations. Credit rating agencies and municipal bond insurers evaluate the quantity and quality of revenues in each case and assign a credit rating based on the individual circumstances. A flat policy would ignore the underlying security provided to each lease obligation.

I would be pleased to provide further explanations to any of these recommendations.

Very truly yours,

Virginia L. Horler

Virginia L. Horler
Managing Director

VLH/ab

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City of Brea

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CALIFORNIA DEBT ADVISORY COMMISSION

June 15, 1992

California Debt Advisory Commission
P. O. Box 942809
Sacramento, CA 94209-0001

RE: Certificates of Participation (COP)

The City of Brea would like to add our name to the list of supportive testimony being submitted to the California Debt Advisory Commission concerning the proper use of Certificates of Participation (COP).

This form of financing has been extremely successful and has experienced an exemplary safety record. Certificates of Participation are one of the few accessible financing mechanisms left in the State of California which can help local governments achieve their capital requirements. No investment is 100% safe, but COP's have an excellent track record which should rate them among the most secure.

We feel the Commission needs to consider the fact that the percentage of negative cases involving COP's would be worthy of only a footnote to the successful ones. Thank you for this opportunity to express our views.

Sincerely,

Ron Isles
Mayor

RI:sar.1 COP6.151

cc: Brea City Council

City Council | Ron Isles *Mayor* | Burnie Dunlap *Mayor Pro Tem* | Carrey Nelson *Councilman* | Glenn G. Parker *Councilman* | Wayne D. Wedin *Councilman*

Civic & Cultural Center•Number One Civic Center Circle•Brea, California 92621-5758•714/990-7600•FAX 714/990-2258

CITY OF SAN FERNANDO
117 Macneil Street
San Fernando, CA 91340-2993
(818) 898-1200

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June 3, 1992

Mr. Steve Juarez, Executive Director
California Debt Advisory Commission
915 Capitol Mall Room 400
P. O. Box 942809
Sacramento, CA 94209-0001

Dear Mr. Juarez,

The City of San Fernando is a strong advocate of the use of Certificates of Participation, especially in these times where it is hard to raise outside capital or finance capital improvements on a pay-as-you-go basis. Also, the difficulty in obtaining a two-thirds vote for passage of general obligation bonds make certificates a desirable method of financing capital improvements.

With the continued deterioration of infrastructure it is critical that this method of financing be continued and even made more attractive for agencies and investors to guarantee the continued flow of funds for capital needs.

In closing, local government is in desperate need for continued support in the use of Certificates of Participation for financing of infrastructure improvements.

Respectfully,

Michael J. Moon
Director of Finance

CALIFORNIA STATE DEPARTMENT OF EDUCATION
721 Capitol Mall; P.O. Box 944272
Sacramento, CA 94244-2720

Bill Honig
Superintendent
of Public Instruction

June 17, 1992

MANAGEMENT ADVISORY NO. 92-04

TO: County and District Superintendents
County and District Chief Financial Officers

FROM: Robert W. Agee
Deputy Superintendent For Field Services

SUBJECT: Criteria and Standards For Temporary Borrowing (Short-Term) Debt Issuance

This advisory contains criteria and standards for use by the State Superintendent of Public Instruction and county superintendents to review debt instruments proposed by local educational agencies (LEAs) having a qualified or negative certification in either the current or prior fiscal year. Although Education Code Section 42133 applies to both temporary (short-term) and long-term debt, due to pending legal issues this management advisory is limited to temporary borrowing which must be repaid in full out of revenues of the fiscal year in which the borrowing occurs. Examples are Tax Anticipation Notes (TANs), Revenue Anticipation Notes (RANs), and Grant Anticipation Notes (GANs). We will be issuing a separate advisory on long-term debt such as Certificates of Participation (COPs) at a later date. This management advisory is part of a series of advisories regarding the provisions of AB 1200 (Statutes of 1991, Chapter 1213); see Management Advisory 92-03 for details concerning the other major provisions of AB 1200.

The purpose of the criteria and standards is to establish statewide guidelines that will promote a uniform basis for approval or disapproval of debt instruments that do not require the approval of the voters of the district. The criteria and standards affect only those LEAs which have a qualified or negative certification during the current or prior fiscal year, therefore, the implementation of these standards will not affect LEAs which have positive certifications. Application of the criteria and standards should facilitate a productive dialogue between the issuing LEA and the approving agency prior to the LEA incurring the debt.

Education Code sections 42133 (a) and (b) read as follows: "(a) A school district that has a qualified or negative certification in any fiscal year may not issue, in that fiscal year or in the next succeeding fiscal year, certificates of participation, tax anticipation notes, revenue bonds, or any other debt instruments that do not require the approval of the voters of the district, nor may the district cause an information report regarding the debt instrument to be submitted pursuant to subdivision (e) of Section 149 of Title 26 of the United States Code unless the county superintendent of schools determines, pursuant to criteria established by the Superintendent of Public Instruction, that the district's repayment of that indebtedness is probable. A school district is deemed to have a qualified or negative certification for purposes of this subdivision if, pursuant to this article, it files that certification or the county superintendent of schools classifies the certification for that fiscal year to be qualified or negative.

(b) A county office of education that has a qualified or negative certification in any fiscal year may not issue, in that fiscal year or in the next succeeding fiscal year, certificates of participation, tax anticipation notes, revenue bonds, or any other debt instruments not requiring the approval of the voters of the district, nor may the county office of education cause an information report regarding the debt instrument to be submitted pursuant to subdivision (e) of Section 149 of Title 26 of the United States Code unless the Superintendent of Public Instruction determines that the repayment of the indebtedness by the county office of education is probable. A county office of education is deemed to have a qualified or negative certification for purposes of this subdivision if, pursuant to the article, it files that certification or the Superintendent of Public Instruction classifies the certification for that fiscal year to qualified or negative. For purposes of this subdivision, "county office of education" includes a school district that is governed by a county board of education."

Temporary Borrowing Debt Issuance

TANs, RANs, and GANs are short-term borrowing instruments used to finance cash flow deficits in anticipation of receiving taxes, other revenues, or grants. Generally, they are issued for 12 months or less and are repaid out of revenues of the fiscal year in which the borrowing occurs.

The keys to determining the probability of debt repayment are a cash flow analysis and an analysis of the LEA's fund balance. These processes should provide the reviewer with assurances that:

- the revenues pledged to repay the note will be received on or prior to the pledge date;
- the amount of the revenues pledged to repay the note are sufficient;
- the note will be repaid in full out of revenues of the fiscal year in which the borrowing occurred;
- the revenues used to repay the note are composed of funding sources which have a high degree of certainty of occurring and in the amount projected.

The cash flow analysis should provide the beginning balance, revenues, expenditures, and ending balance for each month of the fiscal year. The analysis should focus on the unrestricted portion of the General Fund budget as well as any restricted portion of the budget that will impact the unrestricted portion, and should include all the assumptions used. In addition, the LEA should provide the reviewer with trends and composition of revenues, trends and composition of the LEA's expenditures, factors driving those costs, impact of the borrowing, and projected monthly cash balance.

If the repayment provision does not in any way obligate the General Fund, the LEA should perform a similar analysis of the funds or revenues pledged to repay the note.

The Review of the LEA's Cash Flow Analysis

The reviewer should subject each of the LEA's assumptions and projections to a test of reasonableness. This will require the reviewer to examine each assumption and to compare it to what has happened historically and to what is presently occurring. It will also require that the reviewer be familiar with local developments, apportionment schedules, and economic trends at both the state and national level.

After reviewing the trends and composition of both the LEA's revenues and expenditures and the factors affecting them, the reviewer should carefully review the LEA's projected fund balance. If the LEA can meet all of its obligations including repayment of the note and yet maintain a sufficient fund balance then there is a reasonable probability that the LEA will repay its debt.

The two criteria that should be applied to temporary borrowing are: (1) Fund Balance and (2) Cash Flow Analysis. These criteria are the same as those that were adopted by the State Board of Education on July 13, 1990, as part of the criteria for interim financial reports pursuant to Education Code Section 33127.

CRITERIA AND STANDARDS FOR REVIEWING SCHOOL DISTRICT NON-VOTER APPROVED TEMPORARY BORROWING

Criteria	Standards
Cash Flow Analysis	Cash Flow analysis indicates that there will not be a negative cash balance at, or before the end of the fiscal year.
Fund Balance	Expenditures do not exceed revenues, and do not create a negative fund balance.
	Reserve for Economic Uncertainties is not less than the following percentages as applied to total expenditures, transfers out and uses:

the greater of 5% or $50,000	for districts with 0 - 300 ADA
the greater of 4% or $50,000	for districts with 301 - 1,000 ADA
3%	for districts with 1,001 - 30,000 ADA
2%	for districts with 30,001 - 400,000 ADA
1%	for districts with 400,001 and over ADA

Budgeted salaries and benefits, reserves, and/or unappropriated fund balance are sufficient to address pending salary and benefit negotiations.

CRITERIA AND STANDARDS FOR REVIEWING COUNTY OFFICE OF EDUCATION NON-VOTER APPROVED TEMPORARY BORROWING

Criteria	Standards
Cash Flow Analysis	Cash Flow Analysis indicates that there will not be a negative cash balance at, or before the end of the fiscal year.
Fund Balance	Expenditures do not exceed revenues, and do not create a negative fund balance.
	Reserve for Economic Uncertainties is not less than the following percentages as applied to total expenditures, transfers out and uses:

the greater of 5% or $50,000 for Class 8 counties
the greater of 4% or $50,000 for Class 7 counties
3% for Classes 4, 5, and 6 counties
2% for Classes 1, 2, and 3 counties

Budgeted salaries and benefits, reserves, and/or unappropriated fund balance are sufficient to address pending salary and benefit negotiations.

Should you have any questions relating to the criteria and standards, please contact LeRoy Munsch in the Office of School Business Practices at (916) 322-1471.

NOTICE

To the extent that this Management Advisory contains guidelines in addition to recitation of the law, the guidelines are exemplary only and compliance with them is not mandatory.

THE UTILIZATION OF CERTIFICATES OF PARTICIPATION FOR PUBLIC TRANSIT IN CALIFORNIA

REMARKS BY

KEITH D. CURRY
MANAGING DIRECTOR
PUBLIC FINANCIAL MANAGEMENT, INC.

JUNE 18, 1992

My name is Keith Curry, I am a Managing Director with the firm Public Financial Management, Inc. (PFM), is San Francisco.

I have served as financial advisor to the San Diego Metropolitan Development Board, Sacramento Regional Transit, and the Los Angeles County Transportation Commission (acting on behalf of the Southern California Rapid Transit District, the county of Los Angeles and the cites of Los Angeles and Santa Clarita), in implementing more than $212 million in certificates of participation (COPs) for the acquisition of transit buses.

The utilization of COPs for the acquisition of transit buses is a relatively new development, resulting from amendments to the Federal Surface Transportation and Uniform Relocation Act of 1987 and continued in the Intermodal Surface Transportation Efficiency Act of 1991. These Acts provided that debt service on leases are eligible for Federal funding participation at the existing statutory match ratio. This ratio is currently 80% Federal 20% local.

This change allowed transit agencies to issue debt, secured in part by their future Federal formula assistance grants. This change is a major benefit for transit agencies, particularly in growing areas of the nation like California.

Prior to this provision, transit agencies were required to defer purchases and allow their grants to accumulate in the U.S. Treasury until they had enough funds to proceed with their bus procurements or facility construction As an alternative, they would segment their bus procurements, resulting in smaller procurements, higher per unit costs and additional procurement requirements.

The ability of transit operators to utilize COP financing has eliminated the need for both of these approaches.

In addition to allowing more rational and cost effective procurements, COP financing also results in more efficient cash management of local funds required for the match portion of the Federal grant. Under a cash scenario, the local transit agency must provide 20% of the project cost from local funds. Under a COP scenario, the local agency must only provide 20% of the *debt service payment*. This provides significant cash flow relief to the transit operator and also allows the balance of the local match required for the grant to be invested at a rate higher than the COP borrowing rate. By doing this, the transit operator not only covers the additional interest expense related to the local portion of the financing, but actually generates additional funds for local transit purposes.

This savings allows the transit operator to enjoy a stronger cash position or to invest in additional capital projects, reducing the impacts of inflation and improving local transit service.

The positive effects of COPs for transit capital programs can be seen by examining some of the recent transactions;

In 1990, the San Diego Metropolitan Development Board acquired 130 new buses through a $41 million COP issue. This financing allowed the replacement of one of the oldest bus fleets in the nation. On a present value basis, the transit agency saved over $4 million in costs on this procurement. Rather than multiple procurements over four and one half years to match the cash flow, all buses were able to be procured at the same time.

Of equal importance is the fact that San Diego now has the ability to spend $40 million on additional capital projects over the next four and one half years. Had COP financing not been available, no other projects besides the bus acquisition could be funded.

In Sacramento, 75 Compressed Natural Gas (CNG) buses are baing acquired through a $43 million COP financing. Here again, three years were saved in this procurement due to inadequate pay-as-you go cash flow.

Savings due to inflation and additional investment income will result in a $4 million positive benefit to the transit agency.

In addition, Sacramento can address nearly $40 million in additional capital needs.

In Los Angeles, a $115 million bus procurement for the Southern California Rapid Transit District will save $2.7 million in local match funds while allowing $81 million in additional needed projects to be funded.

Had COPs not been available, the SCRTD would have faced service cutbacks and an unfunded deficit liability.

As you can see, COPs provide significant additional spending power over pay-as-you go approaches. Our experience indicates that the ratio is $1.00 in leveraged COPs results in $1.84 in spending capacity. This is a significant benefit to California transit agencies.

Let me address briefly the unique nature of COPs supported by Federal grants. The transit structure we have designed and implemented here in California represents the most significant utilization of Federal grants of which we are aware. Our structure avoids the problem of "Federal Guarantee" through the nature of the additional revenue sources utilized and the form of the Federal commitment.

We have been successful in obtaining "A1" and "A" ratings and have achieved strong investor demand. We would note that our ratings are comparable to the underlying ratings of the issuing transportation agencies thus indicating the absence of a penalty over general obligation or revenue bonds.

Experience indicates that insurance or credit enhancement is *not* required to effectively market these securities and that additional costs of issuance are not required. Indeed, the utilization of the California Transit Finance Corporation structure has enabled significant savings to be achieved in cost of issuance.

Finally we would note that the ability to use the COP approach with Federal transit assistance funds is rooted in its status as a *lease* obligation. Federal funds can only be used for lease related principal and interest. Accordingly, Federal transit assistance funds could not be used for general obligation or revenue bond debt.

This requirement would cause California transit agencies to be severely disadvantaged, and perhaps be precluded in continuing to take advantage of this approach should COPs be restricted or limited in their use as a debt vehicle for California public agencies. The impact on transit would be several million in lost spending capacity and increased project costs.

We strongly support the continuation of COP financing as a means of leveraging Federal transit assistance.